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IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

HAROLD M. PROVIZER and JOAN PROVIZER,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE

Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

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PETITION FOR A WRIT OF CERTIORARI

STUART A. SMITH *
JORDAN I. BAILOWITZ
PIPER & MARBURY
31 West 52nd Street
New York, NY 10019-6118
(212) 261-2000
Attorneys for Petitioners
* *Counsel of Record*

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QUESTION PRESENTED

Whether the penalty provided by Section 6659 of the Internal Revenue Code of 1954 for an underpayment of tax that "is attributable to a valuation overstatement" can be imposed even when the underpayment of tax rests upon grounds that are wholly independent of any overvaluation statement, *viz.*, that the transaction lacked economic substance and the equipment in question was not placed in service during the taxable year in which the tax credits were claimed.

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COMMISSIONER OF INTERNAL REVENUE

Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

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PETITION FOR A WRIT OF CERTIORARI

Harold M. Provizer and Joan Provizer petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, pp. 1a-6a) is not officially reported. The memorandum findings of fact and opinion of the Tax Court (App., *infra*, pp. 7a-62a) are not officially reported.

JURISDICTION

The judgment of the court of appeals was entered on July 7, 1993. By order dated September 24, 1993, Justice Stevens extended the time within which a petition for a writ of certiorari could be filed to and including

December 4, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTE INVOLVED

The provisions of Section 6659 of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth at App., *infra*, pp. 63a-64a.

STATEMENT

This federal income tax case presents the question whether the Commissioner of Internal Revenue can impose the valuation overstatement penalty provided by Section 6659 of the Internal Revenue Code even when the underpayment in tax stands on grounds that are wholly independent of any valuation overstatement.

The pertinent facts can be summarized as follows: During the taxable year 1981, petitioner Harold M. Provizer [1] invested $8,333 to purchase a 16.67 percent interest in a general partnership known as DL and Associates, which in turn invested $50,000 to acquire a 6.188 percent limited partnership unit in a New York limited partnership known as the Clearwater Group. Clearwater was formed to engage in the business of leasing, as lessee, and thereafter licensing, as licensor, six Sentinel EPE Recyclers. These machines were specially designed to recycle low density polyethylene scrap and thereby enable plastics manufacturers to purchase less expensive raw material than newly-processed oil-based resin (App., *infra*, pp. 2a, 24a; R. 31: Tr. 121-122, 315-316).[2] Prior to investing in Clearwater, petitioner consulted with various profes-

[1] Joan Provizer is a party to this proceeding solely because she filed a joint federal income tax return with her husband for the taxable year at issue (App., *infra*, p. 12a).

[2] "R." references are to the joint appendix filed in the court of appeals. For the convenience of the Court, we are lodging a copy of Volume 6 of the joint appendix with the Clerk which contains the designated portions of the trial transcript.

sional advisors and persons familiar with the oil industry. Thereafter, petitioner concluded that the proposal had a good potential for economic profit because it was generally believed that the dramatic increase in the price of oil during 1976-1981 would continue. Since plastic resin prices are directly tied to the price of crude oil, continued increases in the price of oil would increase demand for recycled plastic material (R. 31: Tr. 1070-1074).

The recyclers were manufactured by Packaging Industries Group, Inc. ("PI"), a privately-held company based in Hyannis, Massachusetts. During 1981 (the taxable year at issue) and for several years thereafter, PI was one of the major manufacturers of thermoplastic and other types of packaging machinery. Through a series of transactions, the machines were sold by PI to another corporation, and ultimately leased under a "safe harbor" leasing arrangement [3] to the Clearwater Group, which then licensed the machines back to PI for sublicense to end-users who would use them to recycle plastic scrap. Supported by a tax opinion rendered by the major New York City law firm of Windels, Marx, Davies & Ives,[4]

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[3] Section 168(f)(8) of the Internal Revenue Code of 1954, in effect for the year at issue (1981), provided that if the parties to certain agreements known as safe-harbor leases met certain requirements, the agreement would be regarded as a lease for tax purposes. As a result, the designated lessor would be treated as the owner of the property and the designated lessee would be treated as the lessee of the property without regard to the economic substance of the transaction.

[4] The tax opinion was prepared by John Y. Taggart, a prominent tax lawyer in New York City. Taggart was the head of the tax department of Windels, Marx, Davies & Ives and taught tax law as an adjunct professor at New York University Law School. Prior to his entry into private practice, Taggart had served in the Office of Tax Legislative Counsel of the Treasury Department, as a full-time member of the faculty of the New York University Law School and as editor-in-chief of the Tax Law Review (App. *infra*, p. 15a). The accuracy of Taggart's legal opinion was also confirmed by Price Waterhouse (R. 31: Tr. 1006-1007). In the course of preparing the

petitioner claimed on his 1981 tax return an investment tax credit of $7,195, an additional business energy investment credit of $7,195, and a deduction of $6,668 that was attributable to his aliquot share of Clearwater's outlay for rent for the machines (App., *infra,* p. 2a).

On audit, the Commissioner of Internal Revenue determined a deficiency in petitioner's 1981 tax liability of $17,724 by disallowing all of his claimed credits and deductions attributable to his Clearwater investment on the ground that the Clearwater transaction was a sham. The Commissioner also assessed a 30 percent penalty for valuation overstatement equal to $4,317, and an additional negligence penalty of $866 plus 50 percent of the interest due on the deficiency (App., *infra,* pp. 2a-3a).

After a trial in the United States Tax Court before Special Trial Judge Norman H. Wolfe, the Tax Court rejected petitioner's contentions that his claimed tax benefits were protected from disallowance because the transaction qualified under the safe-harbor lease provisions. Instead, it concluded that the Clearwater transaction was a sham because it lacked economic substance and business purpose and disallowed the claimed deduction and credits (App., *infra,* pp. 40a-59a). The Tax Court also upheld the Commissioner's penalty determinations for valuation overstatement and negligence (App. *infra,* pp. 59a-61a). With respect to the valuation overstatement penalty, the Tax Court found that the value of the recycler machines was approximately $50,000, rather than the $1,162,666 price that the Clearwater Group paid for each of them. Without further analysis, the Tax Court upheld the penalty, concluding that "[p]etitioners'

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offering memorandum and tax opinion in the Plastic Recycling partnerships, the Windels firm undertook extensive efforts to verify PI's representations that the Recycler was unique. These efforts included Taggart's personal consultation of technical journals and other manufacturers' machine brochures (R. 31: Tr. 284, 304, 308, 316-317).

valuations are by definition overstated within the meaning of section 6659" (App., *infra*, p. 61a).[5]

On appeal, the court of appeals affirmed the Tax Court's decision in an unpublished *per curiam* opinion (App., *infra*, pp. 1a-6a). It first upheld the Tax Court's holding that petitioner was not entitled to the tax benefits he claimed on his return with respect to the Clearwater investment. In so ruling, the court stated that the transaction "was indeed a sham," which it defined as one that "has no economic substance" and "[one in which] the taxpayer did not engage . . . with any business purpose other than to generate tax benefits" (App., *infra*, p. 4a). As the court viewed the matter, "there was little opportunity for Clearwater to realize an economic profit from this transaction" (*id.*) because of the substantial price it paid for the machines. The court also based its decision on the fact that the general partner "had no experience in the plastics industry and devoted little time to managing the business activities of Clearwater" (App. *infra*, pp. 4a-5a).

The court of appeals further acknowledged that "two of the recyclers ostensibly leased by Clearwater were broken in 1981 and were never placed in service, and the machines that were put in service were used only sparingly" (App. *infra*, p. 4a). Despite this concession, the court nevertheless upheld the Commissioner's overvaluation penalty assessment even though the underpayment of tax was not "attributable to" any overvaluation statement within the meaning of Section 6659(a) of the Code but

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[5] Notwithstanding the evidence of petitioner's careful investigation and his good faith belief (consistent with the general expectation in December 1981) that the price of oil would continue to increase so as to confirm the economic soundness of the plastics recycling process, the court of appeals without any elaboration upheld the Tax Court's imposition of the negligence penalty (App., *infra*, p. 5a). However, on similar facts, the Tax Court has struck down the negligence penalty when the taxpayer demonstrated that his investment was prompted by the energy crisis in the late 1970s. *See Krause v. Commissioner*, 99 T.C. 132 (1992).

stood on independent grounds, *viz.*, that the transaction lacked economic substance and that the machines were not placed in service in 1981 (App., *infra*, p. 5a). In so ruling, the court did not address the conflicting decisions of two circuit courts of appeals and the Tax Court that have held that the Section 6659 overvaluation penalty cannot be imposed in such circumstances. *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988) (property not placed in service); *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990) (total disallowance); *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990) (agreeing with *Todd*); *McCrary v. Commissioner*, 92 T.C. 827, 851-855 (1989) (total disallowance). Rather, the court followed its prior contrary decision in *Illes v. Commissioner*, 982 F.2d 163, 167 (1992), which it cited for the proposition that the Section 6659 penalty is applicable when the lack of economic substance is due to an overvaluation. In *Illes*, the court below had earlier endorsed the broad ruling adopted by the Eighth Circuit in *Massengill v. Commissioner*, 876 F.2d 616, 619-620 (1989), that "When an underpayment stems from disallowed depreciation deductions or investment credit due to lack of economic substance, the deficiency is attributable to overstatement of value, and subject to the penalty under section 6659."

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals squarely conflicts with decisions of both the Fifth and Ninth Circuits with respect to the question whether the overvaluation penalty provided by Section 6659 of the Internal Revenue Code can be imposed when the underpayment in tax is attributable to grounds that are wholly independent of any overvaluation statement. Those courts have held that the penalty cannot be imposed in such circumstances. On the other hand, the Second and Eighth Circuits are aligned with the court below and have upheld the penalty whenever there is an overvaluation statement even in the absence of any directly proximate causative relationship between the overvaluation statement and the underpayment in tax.

The question of statutory interpretation upon which this case turns has substantial administrative importance. There are thousands of persons throughout the country who have claimed tax credits as a result of their participation in transactions that are virtually identical to the very investment involving the same equipment at issue in this case. Moreover, the fact that the Commissioner has thus far advanced his position in this case in four circuits suggests that there are many other cases pending administratively and in the courts involving other transactions in which the overvaluation penalty has been assessed in comparable circumstances. This Court should therefore grant certiorari to resolve the conflict among the various courts of appeals and establish a uniform national rule for the benefit of both taxpayers and the Internal Revenue Service.

1. a. Section 6659(a) of the Internal Revenue Code imposes a special penalty equal to a percentage of up to 30 percent on "an underpayment of the tax . . . which is *attributable to* a valuation overstatement . . . ." (emphasis supplied). Section 6659(c) defines a "valuation overstatement" as occurring "if the value of any prop-

erty, or the adjusted basis of any property, claimed on any return exceeds 150 percent of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)."

As this Court has long admonished, "The plain meaning of legislation should be conclusive, except in the 'rare case [in which] the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters.'" *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 242 (1989), quoting from *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982). This maxim applies with special force to tax statutes where Congress speaks with particular precision. "As we have often said, 'the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses.'" *Malat v. Riddell*, 383 U.S. 569, 571 (1966), quoting from *Crane v. Commissioner*, 331 U.S. 1, 6 (1947).

In interpreting tax statutes, the Court has looked to the relevant definitions of words in the principal standard dictionaries. *Crane v. Commissioner, supra.* By its plain and literal terms, the Section 6659 penalty can be imposed only where the underpayment in tax is "attributable to a valuation overstatement." Here, the standard dictionary definition of the word "attributable" is "capable of being attributed" or "explain[ed] by way of cause." *See* Webster's Seventh New Collegiate Dictionary. Accordingly, the statute prescribes a direct causative relationship between the valuation overstatement and the underpayment in tax as the critical prerequisite for application of the penalty. Thus, if the taxpayer claims an investment credit or depreciation deduction for property with a claimed basis of $150,000 but the correct amount of the basis is only $100,000, the appropriate disallowances will be determined and the penalty will apply. However, if it turns out that the property is not eligible for the credit or the allowance for depreciation, or was not placed in

service during the tax year at issue, the deduction or credit will be totally disallowed. In such a case, the Section 6659 penalty cannot apply because the underpayment in tax is not "attributable to a valuation overstatement" but is attributable to a ground that is independent of the claimed valuation. The correctness of this proposition becomes self-evident if one were to compare the taxpayer's tax liability computed without the improperly claimed deduction or credit with his tax liability computed on the assumption that there was a valuation overstatement. In both instances, the taxpayer's tax liability would be precisely the same. Hence, the underpayment in the case of total disallowance cannot be "attributable to" any valuation overstatement. This interpretation is confirmed by the General Explanation of the Economic Recovery Act of 1981, Staff of the Joint Committee on Taxation, 97th Cong., 1st Sess., at 333 (Comm. Print 1981), a source which this Court has characterized as a "compelling contemporaneous indication" of the meaning of revenue statutes. *Federal Power Commission v. Memphis Light, Gas & Water Division,* 411 U.S. 458, 471-472 (1973).

b. The foregoing analysis of the statutory language of Section 6659 has been endorsed by the Fifth and Ninth Circuits. They have held that where, as here, the Tax Court totally disallows a deduction or credit and where overvaluation is not the direct proximate cause of such disallowance, the Section 6659 penalty cannot be imposed. *Todd v. Commissioner,* 862 F.2d 540 (5th Cir. 1988) (property not placed in service); *Heasley v. Commissioner,* 902 F.2d 380 (5th Cir. 1990) (total disallowance); *Gainer v. Commissioner,* 893 F.2d 225 (9th Cir. 1990) (agreeing with *Todd*). On the other hand, the Eighth and Second Circuits have held that where a transaction is determined to be without economic substance, the resulting underpayment in tax is attributable to an "implicit overvaluation" represented by an overstatement in the basis of property. As a result, these courts have

concluded that a transaction that lacks economic substance necessarily contains an overvaluation statement within the meaning of Section 6659(a). *Massengill v. Commissioner*, 876 F.2d 616, 619-620 (8th Cir. 1989); *Gilman v. Commissioner*, 933 F.2d 143 (2d Cir. 1991), *cert. denied*, —— U.S. ——, 112 S.Ct. 871 (1992).

But Section 6659 does not turn on such catch phrases as "logical reliance" or "implicit overvaluation" that are virtually impossible of predictable application. The penalty therefore cannot be presumptively invoked in every case concluding that a transaction lacks economic substance. The operative statutory term is "attributable," which connotes that the overvaluation must be the direct proximate cause of the underpayment. In the absence of such a finding, the underpayment, as in this case, is necessarily "attributable" to a ground other than a valuation overstatement. As a result, the Section 6659 penalty cannot apply because the taxpayer's tax liability will be exactly the same with or without the claimed overvaluation. Indeed, the Second Circuit in *Gilman* acknowledged as much when it observed that applying the penalty in such a case was "not self-evident" and "somewhat strains the natural reading of the statutory phrase 'valuation overstatement . . .'" (933 F.2d at 150, 151).

Although the foregoing decisional law was called to the attention of the court below, it did not address it. Rather, it purported to follow its earlier ruling in *Illes v. Commissioner*, 962 F.2d 163, 167 (6th Cir. 1992),[6] which upheld the penalty in such a case on the basis of the rationale in *Massengill* and its earlier unpublished decision in *Donahue v. Commissioner*, No. 91-1849 (6th Cir. April 7, 1991). These decisions propose the following test: that where the Tax Court disallows deductions or credits because the transaction lacks economic substance, any finding of a valuation overstatement auto-

[6] *Illes* was originally issued as an unpublished decision. However, the court below ordered that it be published shortly before the oral argument in this case. *See* 982 F.2d at 163 n.1.

matically triggers the Section 6659 penalty. For the reasons discussed above, we do not believe that this rationale can be squared with the statutory term "attributable," the pertinent legislative history, or this Court's strict, *i.e.*, literal, construction of penalty statutes such as Section 6659. As this Court has admonished, the law is settled that " 'penalty statutes are to be construed strictly.' " *Commissioner v. Acker*, 361 U.S. 87, 91 (1959), quoting from *Federal Communications Commission v. American Broadcasting Co.*, 347 U.S. 284 (1954). Thus, one "is not to be subjected to a penalty unless the words of the statutes plainly impose it" *Keppel v. Tiffin Savings Bank*, 197 U.S. 356, 362 (1905). Here, neither the statutory language nor the legislative history can be fairly read to justify the imposition of the overvaluation penalty.

Nor do we believe that *Donahue*, *Illes*, *Massengill*, or *Gilman* articulate a workable and objectively predictable standard for the application of the penalty in these cases. In using the word "attributable" in Section 6659, Congress could hardly have intended that the courts would conduct a subjective inquiry that would impose the penalty whenever the underpayment was either "due in part" to any overvaluation (*Massengill*, 876 F.2d at 620 and *Gilman*, 933 F.2d at 151), where the underpayment was "an integral part" of a conclusion that a transaction lacked economic substance (*Donahue*, slip op. 8), where "[t]he entire artifice . . . was constructed on the foundation of the overvaluation" (*Illes*, 982 F.2d at 167), or where the disallowance was "largely because" of the overvaluation (App., *infra*, p. 5a). Rather, the only practicable meaning of the statutory term "attributable" is to limit the Section 6659 penalty to those instances where the overvaluation is the direct proximate cause of the underpayment. Such a rule would conform to the statutory language and legislative history and pay heed to this Court's teaching that tax penalties be strictly construed.

Here, it is clear that the overvaluation was not the direct proximate cause of the underpayment. The Tax

Court totally disallowed petitioner's claimed investment tax and business energy credits on the ground that the transaction lacked economic substance, business purpose and profit motive. Although it found that the machine was worth approximately $50,000, the Tax Court did not reduce petitioner's claimed credits to conform to its finding as to value. Rather, the Tax Court totally disallowed the credits on the basis of lack of economic substance, business and profit motive.

Moreover, any doubt as to whether petitioner's underpayment in tax is attributable to an overvaluation statement is dispelled by the Tax Court's findings that "[t]wo of the six machines never worked and remained for most of 1981 through 1985 in a PI warehouse" and that "[o]ne machine was sent unsolicited to a company which refused to take the machine and immediately returned the invoice to PI" (App., *infra*, p. 54a). In this respect, the Tax Court further found that "the recyclers were used infrequently and they often were not in use at all" (App. *infra*, p. 31a). Finally, the Tax Court found that "PI failed promptly to pick up . . . the . . . machines rejected by prospective end-users. . ." (App., *infra*, p. 31a). These findings, as affirmed by the court of appeals (App., *infra*, p. 4a), constitute an unquestionably independent basis for disallowance of the credits on the ground that the property was not placed in service because it was not "placed in a condition or state of readiness and availability for a specifically assigned function" Treas. Reg. § 1.46-3(d)(1). In these circumstances, the underpayment in tax is not "attributable" to the valuation overstatement because the direct proximate cause of any underpayment was not a valuation overstatement. By its explicit terms, the Section 6659 penalty is therefore not applicable. *Todd v. Commissioner, supra; Gainer v. Commissioner, supra*; *Heasley v. Commissioner, supra*; *contra, Gilman v. Commissioner, supra.*[7]

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[7] In opposing certiorari in *Gilman* (O.T. 1991, No. 91-642), the Solicitor General took the position that the decision in *Heasley* did

2. The question presented has substantial administrative and continuing importance. While Section 6659 as originally enacted in the Economic Recovery Act of 1981 has been repealed by the Omnibus Budget Reconciliation Act of 1989, the critical statutory language penalizing "any underpayment which is attributable to . . . any substantial valuation misstatement" continues to be employed in the new accuracy-related penalty provision of Section 6662(b)(3) and (e) of the Code.[8] Moreover, we are advised by the Office of the District Counsel of the Internal Revenue Service responsible for the Tax Court litigation of the transaction at issue that approximately 2,500 tax returns claimed precisely the same tax benefits that are affected by the decision below for the tax years 1981 and 1982 and that there are approximately 300

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not conflict with *Gilman*. Seizing upon the fact that the taxpayers in *Heasley* conceded that they were not entitled to their claimed investment tax credit, the Solicitor General claimed that the Fifth Circuit had not directly ruled whether the Section 6659 penalty would apply in a case where the transaction lacked economic substance. We believe that the Solicitor General's argument cannot be reconciled with the Fifth Circuit's broad conclusion that when a credit is disallowed in its entirety, the underpayment is not attributable to the valuation overstatement, but rather "is attributable to claiming an improper deduction or credit" (902 F.2d at 383).

There is, we submit, no meaningful distinction, for purposes of the question of statutory interpretation presented, between the total disallowance in *Heasley* and this case in which a deduction or credit is totally disallowed because the transaction is deemed to lack economic substance. But even assuming *arguendo* the validity of such a distinction, the Solicitor General's Brief in Opposiiton in *Gilman* has already acknowledged the present existence of a conflict. There, he observed (pp. 11-12) that the Fifth Circuit had directly ruled in *Todd* that the Section 6659 penalty could not be applied where, as here, the property had not been placed in service. There is accordingly no question that there is now a square conflict of decisions.

[8] In his Brief in Opposition in *Gilman* (p. 10, n.9), the Solicitor General acknowledged that "[p]rovisions similar to Section 6659 are now found in Section 6662(e), relating to substantial valuation misstatements."

docketed cases in the Tax Court presenting the penalty question in the context of petitioner's investment.[9] If we conservatively assume that approximately 2,000 taxpayers invested an average of $12,500 (one-quarter unit) in identical transactions, the overvaluation penalties plus interest assessed against these taxpayers would total approximately $33 million.[10] Given the Commissioner's position in this test case that was selected to govern the tax treatment of the thousands of taxpayers involved in this investment and the prior and continuing litigation on the penalty question in other transactions, it is fair to assume that there are many other Section 6659 cases presenting this question that are pending administratively and in the courts. Further review by this Court is therefore amply warranted.

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[9] At the trial stage of this case, the Commissioner similarly advised the Tax Court that there were approximately 250 docketed cases and 1,600 undocketed cases involving this transaction (App., *infra*, p. 9a).

[10] We calculate this figure in the following manner. Here, petitioner invested $8,335 ($50,000 × .1667) and was assessed an overvaluation penalty of $4,317. Hence, each dollar invested has resulted in the imposition of an overvaluation penalty of $0.5179. Extrapolating a total nationwide dollar investment of $25 million (2,000 × $12,500) the penalty amount would be $12,947,500. The applicable figure would more than double after the addition of statutory interest.

In July 1993, we filed a Freedom of Information Act request with the National Office of the IRS seeking statistics as to the amount of revenue at stake with respect to the question presented. However, despite repeated requests, the information has not been forthcoming.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

STUART A. SMITH *
JORDAN I. BAILOWITZ
PIPER & MARBURY
31 West 52nd Street
New York, NY 10019-6118
(212) 261-2000
Attorneys for Petitioners
* *Counsel of Record*

December 1993

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 92-1827

HAROLD M. PROVIZER

and

JOAN PROVIZER,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

On Appeal from the Decision of the
United States Tax Court

Decided and Filed July 7, 1993

BEFORE: KEITH and JONES, Circuit Judges; and BROWN, Senior Circuit Judge.

PER CURIAM. Petitioners appeal from a decision of the United States Tax Court determining their liability for income tax deficiencies for the year 1981. They also appeal the Tax Court's decision assessing penalties on the deficiency for valuation understatement and negligence. After reviewing the record, we conclude that the Tax

Court made no clearly erroneous findings of fact and correctly resolved all of the legal issues in this case, and we affirm on the basis of the Tax Court's opinion. *Provizer v. Commissioner,* 63 T.C.M. (CCH) 2531 (1992). We write briefly for additional clarification.

I

The issues in this case center around a complex six-step transaction involving the sale and lease of six machines designed to recycle plastic scrap. The facts are set out more fully in the fifty-two page opinion of the Tax Court, but a fair summary is as follows: In 1981, a corporation called Packaging Industries, Inc. manufactured and sold six Sentinel EPE Recyclers to ECI Corporation for $5,886,000 ($981,000 each) which in turn resold the recyclers to F & G Corporation for $6,976,000 ($1,162,666 each). F & G leased the recyclers to a limited partnership called Clearwater Group, and Clearwater then licensed the recyclers to FMEC Corporation, which sublicensed them back to Packaging Industries. These transactions were structured in such a way that all of the payments between the entities offset each other. Packaging Industries then allegedly sublicensed the recyclers to entities who would use them to recycle plastic scrap. (These six transactions are hereinafter collectively referred to as the "Clearwater Transaction.")

In November, 1981, the petitioners, Harold and Joan Provizer, purchased for $8,333 a share of a general partnership, DL & Associates, that owned a limited partnership share of Clearwater. Through Clearwater, they were able to deduct from their 1981 tax bill an investment tax credit of $7,195 and an additional $7,195 as a business energy investment credit on the recyclers, and $6,668 for Clearwater's operating loss.

In April, 1986, the IRS issued a deficiency notice to the Provizers claiming a $17,724 deficiency in the Provizers'

1981 payment of income tax. The IRS disallowed all of the deductions and credits that the Provizers received from Clearwater on the ground that the Clearwater Transaction was a sham. The IRS also assessed a $4,317 penalty for valuation overstatement and an additional penalty of $866 plus 50% of the interest due on the deficiency for negligent underpayment of taxes. The Provizers filed a timely petition in Tax Court arguing that the sham transaction doctrine should not apply to the Clearwater Transaction because, they contended, the lease between F & G and Clearwater met the requirements of the safe harbor provision for leases under section 168(f)(8) of the 1981 Tax Code.[1] 26 U.S.C. § 168(f)(8) (1982). They also contested the penalties.

The Tax Court, in its detailed memorandum opinion, rejected the Provizers' contention that the Clearwater Transaction was protected by the § 168(f)(8) safe harbor and concluded that the transaction was indeed a sham because it lacked economic substance and a business purpose. The Tax Court also upheld the penalty for valuation overstatement, finding that the actual value of the recyclers was around $50,000 rather than the $1,162,666 each that the F & G Corporation paid for them. Since, it concluded, the underpayment of taxes was directly related to the valuation overstatement, the penalty was appropriate. It also concluded that the IRS correctly assessed the negligence penalty.

On appeal to this court, the Provizers again contend that the § 168(f)(8) safe harbor protects the Clearwater Transaction from application of the sham transaction doctrine. They also contend that the Tax Court's determina-

[1] Section 168(f)(8) was enacted as part of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 201(f)(8), 95 Stat. 172, 214-15 (1981), and has since been repealed by the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 12(b), 98 Stat. 494, 504 (1984).

tion that the transaction was a sham is erroneous. Additionally, they contest the valuation overstatement penalties and negligence penalties.

II

We turn first to the Provizers' contention that the § 168 (f)(8) safe harbor prevents the IRS from inquiring into the economic substance of the Clearwater Transaction. We can find nothing in the language or legislative history of § 168(f)(8) that indicates that Congress intended for § 168(f)(8) to protect a whole series of planned transactions of which a lease is but a part.[2] Accordingly, we conclude that the Tax Court could properly apply the sham transaction doctrine to the case at bar if the transaction was shown to be a sham.

We further conclude that Tax Court correctly determined that the transaction was indeed a sham. A transaction is a sham if it has no economic substance and the taxpayer did not engage in the transaction with any business purpose other than to generate tax benefits. *Bryant v. Commissioner*, 928 F.2d 745, 748 (6th Cir. 1991); *Rose v. Commissioner*, 868 F.2d 851, 853 (6th Cir. 1989). Given that F & G paid $1,166,000 each for the recyclers, there was little opportunity for Clearwater to realize an economic profit from this transaction. Further, two of the recyclers ostensibly leased by Clearwater were broken in 1981 and were never put into service, and the machines that were put into service were used only sparingly. The record also reveals that Packaging Industries insured the recyclers against risk of loss or destruction for $55,000 per machine with a $25,000 deductible. We also note that Sam Winer, the sole general partner of Clearwater, had no experience in the plastics

[2] The Tax Court declined to decide whether the lease did indeed comply with the § 168(f)(8) safe harbor, reasoning that such a determination was not necessary because the lease could not be separated from the rest of the Clearwater Transaction.

industry and devoted little time to managing the business activities of Clearwater. Thus, we conclude that the Tax Court correctly concluded that the Clearwater Transaction was a sham because it had no business purpose other than to generate tax benefits and had little opportunity to make an economic profit.

III

The Provizers next contend that the Tax Court erred in imposing a penalty for valuation overstatement. Section 6659 of the Tax Code permits the Commissioner to assess a penalty on any underpayment of tax due to a valuation overstatement. 26 U.S.C. § 6659 (1982). The Provizers contend that this penalty is inappropriate in this case because the underpayment was caused by the IRS' disallowance of the entire deduction on the basis that the transaction was a sham, not simply by a valuation overstatement.

In *Illes v. Commissioner*, 982 F.2d 163, 167 (6th Cir. 1992), this court held that when an underpayment of taxes is caused by disallowance of a deduction for lack of economic substance and the lack of economic substance is due to an overvaluation, "the deficiency is attributable to an overstatement of value and is subject to the penalty under section 6659." In the case at bar, the transaction was found to be a sham largely because the recyclers were overvalued; thus, under our rule in *Illes*, we conclude that the valuation overstatement penalty assessed in the instant case was appropriate.

IV

The Provizers next contend that the Tax Court erred in assessing a penalty for negligent underpayment of taxes pursuant to § 6653(a) of the Code. 26 U.S.C. § 6653(a) (1982). Our review of the record, however, convinces us that the Tax Court correctly assessed the negligence penalty against the Provizers.

V

For the reasons stated above, we AFFIRM the decision of the Tax Court on the basis of its opinion.[3]

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[3] The court acknowledges receipt of the appellants' letter addendum to their brief dated June 22, 1993. After consideration, we do not feel that the Carmagnola reports would change the result in this case.

APPENDIX B

T.C. Memo. 1992-177

UNITED STATES TAX COURT

HAROLD M. PROVIZER and JOAN PROVIZER,
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 27141-86. Filed March 25, 1992.

During 1981, Ps purchased a second-tier partnership interest in a sale-leaseback transaction structured around plastics recycling equipment. The partnership here is one of a group of plastics recycling transactions which initially had been planned to take advantage of tax credits and deductions. Subsequently, appropriate product and marketing were developed as a framework for the tax and financial design. The initial transaction planning had been modified in an effort to take advantage of the newly enacted safe-harbor leasing provisions.

1. *Held,* the transaction here in issue is so lacking in economic substance that it is disregarded for Federal income tax purposes and respondent's determination of deficiency in tax is sustained.

2. *Held further,* respondent's determination of additions to tax under secs. 6653(a) and 6659, I.R.C., are sustained.

3. *Held further,* respondent's determination of increased interest on tax-motivated transactions under sec. 6621(c), I.R.C., is sustained.

Bernard S. Mark, Richard S. Kestenbaum and *Deborah S. Hack,* for petitioners.

Mary Hamilton and *Michelle S. Gormley,* for respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FAY, *Judge*: This case was assigned to Special Trial Judge Norman H. Wolfe pursuant to the provisions of section 7443A(b) and Rules 180, 181, and 183.[1] The Court agrees with and adopts the opinion of the Special Trial Judge, which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

WOLFE, *Special Trial Judge*: Respondent determined a deficiency of $17,724 in petitioners' joint Federal income tax for 1981 and additions to tax that year in the amount of $4,317 under section 6659 for valuation overstatement, in the amount of $886 under section 6653(a)(1) for negligence, and under section 6653(a)(2) in an amount equal to 50 percent of the interest due on the underpayment attributable to negligence. Respondent also determined that interest on deficiencies accruing after December 31, 1984, would be calculated at 120 percent of the statutory rate under section 6621(c).

This case has been tried and briefed as a lead case for limited partners in programs involving the leasing of Sentinel Recyclers which sometimes are referred to as Plastics Recycling programs. Plastics Recycling programs

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[1] All section references are to the Internal Revenue Code in effect for the tax year at issue, unless otherwise indicated. All Rule references are to the Tax Court Rules of Practice and Procedure.

involved the promotion of expanded polyethylene (EPE) recyclers during 1981 and expanded polystyrene (EPS) recyclers during 1982. Petitioners in the instant case are only representative of investors in 1981 partnerships and the machines are only representative of Sentinel EPE Recyclers.

Petitioners in approximately 250 docketed cases participated in Plastics Recycling programs by investing either in Sentinel EPE Recyclers in 1981 or Sentinel EPS Recyclers in 1982 or both. Some of the parties in these docketed cases have executed stipulations in which they have agreed to be bound by the outcome of this litigation with respect to all deductions, credits, additions to tax, and increased rate of interest resulting from their investment in the Sentinel Recyclers. In addition, respondent has indicated that approximately 1,600 undocketed cases involve Plastics Recycling issues.

In *Greene v. Commissioner*, 88 T.C. 376 (1987), this Court denied petitioners' motion for summary judgment and held that the safe-harbor leasing rules of section 168(f)(8) do not prevent the application of the sham transaction doctrine to the Plastics Recycling programs of which the safe-harbor lease was merely a part.

The remaining issues for decision are: (1) Whether the Sentinel EPE Recycler leasing programs constitute a series of sham transactions lacking in economic substance; (2) whether petitioners are entitled to investment tax credits allegedly passed through to them by the Clearwater Group (Clearwater), lessee and licensor of the recyclers; (3) whether the Plastics Recycling programs comply with all of the requirements of section 168(f)(8) and are entitled to the benefits of the safe-harbor lease provisions; (4) whether petitioners are liable for additions to tax under section 6653(a)(1) and (2) for negligence or intentional disregard of rules and regulations and for 50 percent of the interest attributable to negligence; (5) whether petitioners are liable for the ad-

dition to tax under section 6659 for an underpayment of tax attributable to valuation overstatement; and (6) whether petitioners' transactions in the Sentinel EPE Recycler leases were tax-motivated transactions to which interest at 120 percent of the statutory rate would apply, pursuant to section 6621(c).

For convenience, the outline of our findings and opinion is set forth below:

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1. Donald N. Merino .....

2. James D. Fogarty .....

3. Robert F. Staats-Westover and Leonard Sansone .....

4. Albert Spaak .....

5. Samuel Z. Burstein and Stanley Ulanoff ..

B. Respondent's Experts .....

1. Garth Salonder and Janusz Ordover .....

2. Steven Grossman .....

3. Richard S. Lindstrom .....

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FINDINGS OF FACT

Some of the facts have been stipulated, and are so found. The stipulated facts and attached exhibits are incorporated by this reference. Our use of terms such as purchase, recycle, sale, sale-leaseback, lease, license, sublicense, note, and transaction to describe the events is not necessarily to be construed as a finding that the transactions so described had economic substance.

I. BACKGROUND

A. *Petitioners and Other Persons*

Petitioners Harold M. Provizer and Joan Provizer resided in Farmington Hills, Michigan, when they filed their petition. During taxable year 1981, petitioner Harold M. Provizer (petitioner) was a practicing attorney and a member of the Michigan law firm of Provizer, Eisenberg, Lichtenstein, and Pearlman, P.C. His spouse, petitioner Joan Provizer, was not employed outside the home during 1981. Petitioners' gross income for 1981 from wages, interest, dividends, tax refunds, and capital gains was in excess of $190,000 and, consequently, in the absence of substantial deductions or credits, they were subject to payment of Federal income taxes in large amounts.

Petitioner is a limited partner in DL and Associates which is a limited partner in the Clearwater limited partnership. The losses and tax credits at issue in this case

were passed through both of the limited partnerships to petitioner.

David Lichtenstein (Lichtenstein) is a member of the law firm of Provizer, Eisenberg, Lichtenstein, and Pearlman, P.C. and is a partner in DL and Associates.

Fred Gordon (Gordon) is an attorney who holds a master's degree in business administration and who at one time was employed by the Internal Revenue Service. Prior to the date of the Clearwater private placement offering, Gordon had considerable experience involving the evaluation of tax shelters, including formulating opinions regarding the tax shelters' economic vitality, the profit motives involved, and the valuation of the product involved. In 1981, Gordon was of counsel to Provizer, Eisenberg, Lichtenstein, and Pearlman, P.C. He recommended investing in the Clearwater offering to petitioner and his colleagues, as well as to some of Gordon's other clients. Gordon was paid a fee in the amount of 10 percent of each investment he guided to Clearwater. Gordon and Lichtenstein have known each other since childhood and at one time were associated in law practice.

Samuel L. Winer (Winer) is an investor, investment banker, and consultant with offices in Clearwater, Florida. Winer is the general partner in a number of limited partnerships which leased Sentinel EPE Recyclers, including Clearwater, Poly Reclamation Associates, Sunbelt Group, Southeast Recovery Associates, and Esplanade Associates. Winer paid $1,000 for a 1-percent interest in all items of income, gain, deduction, loss, and credit arising from the operations of Clearwater. For his services, Winer received $60,000 out of the proceeds of the Clearwater private offering.

Harris W. Freedman (Freedman) is a licensed certified public accountant in New York who is highly experienced with leveraged leasing. Freedman was the president and chairman of the board of F & G Equipment Corp. (F & G). He is also the named partner in H.W.

Freedman and Co., the accounting firm which prepared the partnership returns for Ethynol Cogeneration, Inc. (ECI), F & G, and Clearwater. Although Freedman's firm did not prepare the initial financial projection included in the offering memorandum, Freedman did review the financial projections and made suggestions as to both format and substance. Freedman owned 94 percent of an EPE recycler.

Raymond Grant (Grant) was a New York investment banker, attorney, and accountant during the year at issue. Formerly, Grant was employed as general counsel and senior vice president at Wadell & Reed, a large mutual fund sales organization. Grant is the president and 100-percent owner of the stock of ECI. Grant was a client of Freedman's firm and had worked with Freedman on a number of equipment leasing deals. Grant became friendly with Stanley Ulanoff after they met on a cruise and was instrumental in the hiring of Stanley Ulanoff as an evaluator of the Plastics Recycling programs. At the time of trial, Grant was retired.

Richard Roberts (Roberts) is a businessman and the general partner in a number of limited partnerships which leased Sentinel EPE Recyclers. Roberts also is a 9-percent shareholder in F & G. Roberts and Grant together have been general partners in other investments. Roberts currently maintains his address in Paris, France. Roberts was a client of Freedman's firm in the 1970's and maintained the following address with Grant from 1982 through 1985:

Grant/Roberts
Investment Banking
Tax Sheltered Investments
745 Fifth Avenue, Suite 410
New York, New York 10022

Elliot I. Miller (Miller) is a practicing attorney who is experienced in tax matters and who was employed as corporate counsel to Packaging Industries Group, Inc.

(PI), for 29 years and at all times relevant to this case. Miller is also a shareholder of F & G. He shared office space with Grant and Roberts during 1982 through 1984. Miller represented Grant personally and Grant's clients who invested in other programs which Grant had promoted. Miller met Grant in the 1970's while Grant was involved in exploiting a coal mine. Miller reviewed the offering memorandum for the same venture. Miller is a long-time friend of Winer.

John Y. Taggart (Taggart) is a well-known tax attorney practicing in New York City. He was acquainted with Miller for about 15 years prior to 1981. Miller recommended that Roberts employ Taggart as counsel to the general partner in the initial Plastics Recycling partnership. Taggart was head of Windels, Marx, Davies & Ives' (WMDI) tax department and taught tax law as an adjunct professor at the New York University Law School. Taggart previously had been employed by the U.S. Treasury Department in the Office of Tax Legislative Counsel and as a full-time member of the faculty of the New York University Law School and editor in chief of the Tax Law Review. Taggart and other members of his firm prepared the offering memorandum, tax opinion, and other legal documents for initial Plastics Recycling partnership, for the Clearwater partnership, and for about 16 other Plastics Recycling partnerships. Taggart owned a 6.66-percent interest in a second-tier Plastics Recycling partnership.

John D. Bambara (Bambara) is the president of PI, and a member of its board of directors. Bambara, his wife, and daughter own 100 percent of the stock of PI. In addition, Bambara is the president, treasurer, clerk, and director of First Massachusetts Equipment Corp. (FMEC), as well as the owner of 100 percent of its stock. Freedman's firm provided personal tax planning to Bambara.

Robert Gottsegen (Gottsegen) is a businessman active in the plastics industry and a long-time business associate of Bambara. Gottsegen and Bambara are co-shareholders in a number of corporations. Miller has represented Gottsegen and Bambara in several business transactions.

B. *The Entities Involved*

PI, a Delaware corporation with its headquarters in Hyannis, Massachusetts, is a closely-held corporation which manufactures thermoplastic and other types of packaging machinery. In addition to a manufacturing plant in Massachuetts, PI has facilities in California and Connecticut. PI holds itself out as the world's largest manufacturer of blister packaging machinery and as fabricating the industry's widest line of thermoforming machinery, including highly specialized disposable medical and food packaging systems. PI is also a producer of foam ranging in density from 1 to 10 pounds per cubic foot and various thermoplastic products, and is the manufacturer of both Sentinel EPE Recyclers, which recycle expanded polyethylene, and Sentinel EPS Recyclers, which recycle expanded polystyrene.

In its product division, PI develops machinery used for in-house production. To protect what PI considers to be its trade secrets, PI purports to maintain security controls. As part of such arrangements, PI sometimes requires the signing of trade secret agreements and sometimes restricts visitors from being admitted to certain facilities. PI does not file for patents on its inventions, allegedly to make PI's designs unavailable to potential competitors.

ECI, a New York S corporation, was organized in 1980 and was solely owned by Grant. ECI was formed by Miller for Grant in connection with Grant's involvement with the manufacture of machinery for cogeneration.

F & G, a New York corporation which was organized in 1979 as a subchapter S corporation, was owned equally by Freedman and Grant. F & G was organized to partici-

pate in leveraged leasing transactions and initially engaged in computer leasing. On August 11, 1982, F & G was merged into a Delaware corporation. Miller reorganized F & G as a subchapter C corporation to act as the safe-harbor lessor and to satisfy the requirements of section 168(f)(8). F & G was chosen to act as the safe-harbor lessor because while participating in leveraged leasing, F & G had accumulated depreciation and net operating losses which could offset taxable income earned in the Plastics Recycling program. Moreover, F & G had a minimal net worth which would allow a low cost of entry for needed new shareholders.

Grant sold his entire interest in F & G and Freedman retained only a 9.1-percent interest. Ten new shareholders, including Miller and his secretary Beryl Sherlock, Roberts and his secretary Denise Sausa, Gottsegen, Anthony Giovannone (Giovannone), executive vice president of PI, and Richard Kestenbaum, lead counsel for petitioners in this case, were added for a nominal capital investment of approximately $100 each.

Clearwater, a New York limited partnership formed on November 17, 1981, is one of many Plastics Recycling partnerships in which Winer is the general partner. Clearwater was set up by Winer when he realized that another Plastics Recycling private offering had attracted more investors than could be accommodated.

During 1981, Clearwater entered into leasing arrangements with respect to six Sentinel EPE Recyclers with serial numbers ranging from 395-81-047 to 395-81-052. Clearwater's 1981 Federal income tax return listed licensing as its principal business and recycling equipment as its principal product.

FMEC is a Massachusetts corporation which was organized on May 13, 1981, for the purpose of licensing the use of Sentinel recycling equipment. FMEC was owned entirely by Bambara and licensed the recyclers exclusively to PI.

II. *The Transaction or Deal*

A. *Planning and Development of the Deal*

In the spring of 1981, Grant had a discussion with Miller regarding energy tax credits for recycling equipment. Sometime after this discussion, Gottsegen was considering the installation of energy saving equipment at Bee Plastics, one of his companies, and asked Miller about available tax credits. Gottsegen also inquired about "off-balance-sheet financing", meaning a financing arrangement in which the obligation to repay the money raised either would be entirely unnoted on the balance sheet or would be reflected only as a footnote. Gottsegen asked Miller if PI had equipment that could be used to take advantage of off-balance-sheet financing and tax credits.

Miller contacted Bambara to discuss the idea. Bambara told Miller about the recycler prototype, which Bambara thought might be suitable for a venture centering around benefits from tax credits. Miller set up a meeting among Grant, Bambara, Gottsegen, Giovannone, and Miller.

At the meeting, Bambara discussed the recycling equipment PI had developed in response to PI's actual or potential problems with scrap disposal. He also referred to PI's ability to manufacture recyclers because of available underutilized plant facilities. Bambara mentioned PI's proprietary interest in the prototype recycler and PI's pricing policies, which PI supposedly regarded as a trade secret. Bambara suggested a price of $1 million for each recycler. After the initial meeting, Grant asked Miller to discuss the venture with Freedman, his personal accountant, and with Roberts, who shared office space with Grant. Miller met with Grant, Freedman, and Roberts and recommended that they hire their own counsel. Miller recommended Taggart, a well-known tax lawyer and tax partner at WMDI, and an adjunct professor of tax law at New York University Law School.

At one or both of these meetings, the parties discussed setting up a transaction in the form of a leveraged lease.

Roberts, Grant, and Miller met Taggart and discussed the structuring of transactions through limited partnerships to achieve the flow-through of tax deductions and credits. Roberts then hired Taggart to represent him in the recycling transactions.

Shortly thereafter, Taggart, Grant, Freedman, and Roberts signed secrecy agreements and toured PI's headquarters in Hyannis, Massachusetts. While there, they viewed the prototype recycler and decided to go forward with the venture. After the parties agreed, the prototype was scaled down to a more compact machine that could be used by converters.

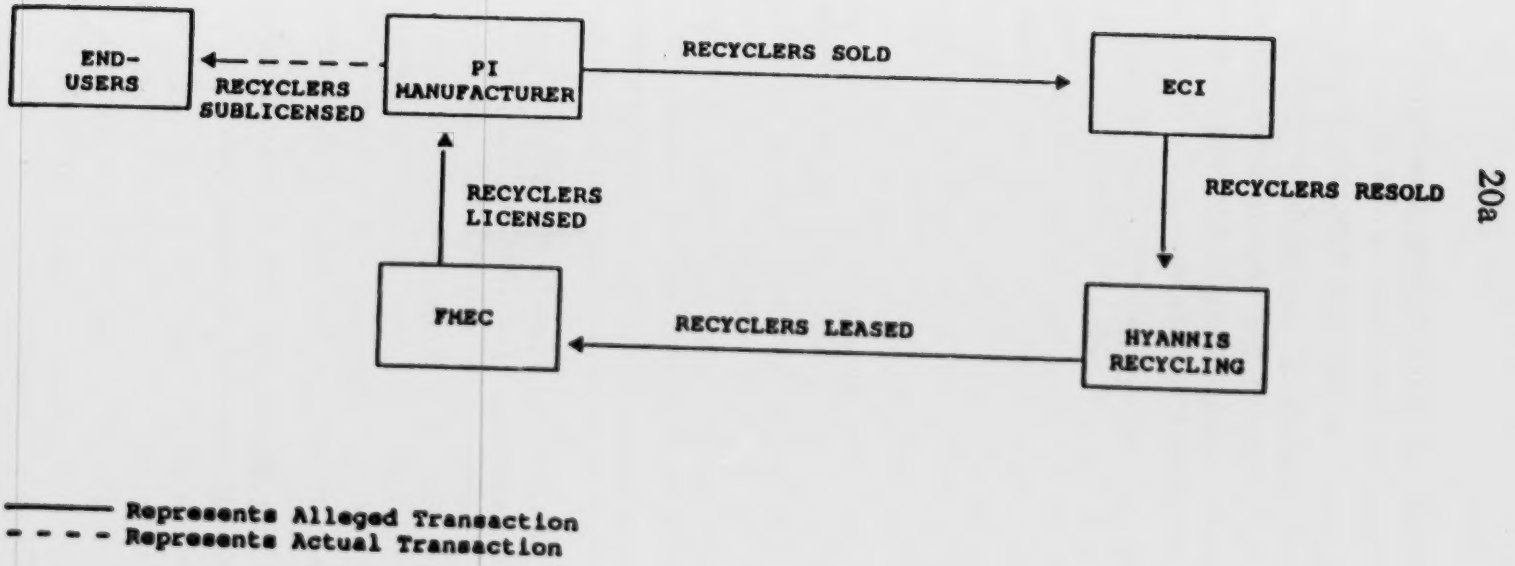
Under the arrangement as initially conceived, Grant, the investment banker, was given an exclusive 5-year right of first refusal for any recycling equipment developed by PI, but was not obligated to purchase any recyclers. PI would develop and manufacture down-sized recyclers. PI also would control and be responsible for placement of the recyclers with end-users and arrangements for collection or disposition of the product of the recyclers.

Initially, the Plastics Recycling transaction was to be a sale-leaseback. The plan involved the syndication of limited partnerships and the sale and leaseback of Sentinel EPE Recyclers financed primarily with nonrecourse notes. A partnership called Hyannis Recycling Associates (Hyannis) was organized with Roberts as its general partner. Taggart drafted the offering memorandum.

The transaction was structured as a series of simultaneous transfers as illustrated.

ILLUSTRATION 1

HYANNIS TRANSACTION: PATH OF RECYCLERS (PRIOR TO ERTA)



The Hyannis transaction, as initially conceived, involved the proposed sale of recyclers to ECI, which was 100-percent owned by Grant, the holder of an exclusive agreement to purchase the Sentinel Recyclers. ECI then would sell the machines to Hyannis which would lease them to FMEC.

FMEC was interposed bteween the lessor partnership (Hyannis) and the lessee (PI) to license the recyclers to PI on a month-to-month basis. This arrangement supposedly was designed to eliminate any need for reporting a capital lease on PI's balance sheet and to circumvent financing restrictions imposed on PI by an unrelated prior bank loan agreement. To complete the sale-leaseback, FMEC licensed the recyclers to PI. The Hyannis transaction closed on July 31, 1981.

After the Hyannis transaction closed, the safe-harbor leasing rules were enacted as part of the Economic Recovery Tax Act of 1981 (ERTA), Pub. L. 97-34, 95 Stat. 172. These rules provided that qualifying transactions would be treated as leases for Federal income tax purposes and included a 90-day window during which transactions completed within the 90 days prior to the date of enactment could be restructured. Roberts asked Miller and Taggart whether it was possible to restructure the transaction to fall within the new rules.

To fall within the safe harbor, the Hyannis transaction had to meet certain statutory requirements. One of these requirements was that the safe-harbor lessor be, among other things, a corporation other than a subchapter S corporation or personal holding company, including a closely held corporation in which five shareholders own 50 percent or more of the stock. Sec. 168(f)(8)(B)(i). To meet the safe-harbor requirement, F & G, a corporation closely held by Freedman and Grant, was reorganized as a subchapter C corporation. In addition, 10 new shareholders invested amounts in F & G so that F & G no longer was closely held. At the same time,

Grant sold his entire interest in F & G and Freedman sold all but 9.1 percent of his interest in F & G.

The Hyannis transaction was restructured in a manner designed to take advantage of the safe-harbor provisions. As part of this restructuring, F & G became the safe-harbor lessor. Subsequent Plastics Recycling programs, including the Clearwater offering, were structured in a manner designed to take advantage of the new statutory safe-harbor opportunities.

B. *Development of a Machine to Fit Requirements of the Deal*

Polyethylene is a large volume commodity usable for many purposes. The total market for polyethylene consists virtually entirely of foam and film applications. About 85 percent of the market involves film applications while foam applications make up only 10 to 15 percent of the market.

Polyethylene foam is a highly porous form of polymer which can be produced in various grades or densities. The density of the foam varies inversely with the volume of trapped gases within the polymer. PI produced polyethylene foam of densities ranging from 1 to 10 pounds per cubic foot.

In the early 1970's, according to PI executives, three events had occurred to provide an impetus for PI to develop a prototype recycying machine for its own use. First, according to these executives, for a brief time PI experienced a shortage in its supply of virgin resin, the material used to produce a variety of PI's products, and paid relatively high prices for supplies of the material. Second, PI's supply of virgin resin from one supplier, Dow Chemical, was limited, at least potentially, since that company competed with PI with respect to some products. Finally, PI's access to some local landfills in Massachusetts was limited or at least questioned by some

town officials. This problem arose because of PI's dumping of large amounts of lightweight scrap which PI generated in manufacturing foam and film products. Under these circumstances, PI began considering alternative ways to dispose of the scrap and provide a constant source of resin. At the same time, PI had excess production capacity in its machinery division which was available for the manufacture of recycling equipment.

Bambara asked William Strzelewicz (Strzelewicz), PI's vice president of manufacturing, to try to develop an in-house method of scrap disposal. On a casual and intermittent work schedule over a number of years, Strzelewicz and his associates in PI's foam division, developed the design for a prototype recycler. After a number of unsuccessful attempts, the prototype was completed in 1979 or 1980. PI did not attempt to market the recycler but did use it in its own operations in Hyannis.

Sometime after Grant and Roberts toured PI's facilities with Taggart and Freedman, viewed the prototype recycler, and decided to go forward with the venture, Bambara instructed Strzelewicz that the machinery division of PI was going to make a scaled-down version of the recycler and that Giovannone, executive vice president of PI, would be in charge of the process.

Under Giovannone's direction, PI's machinery division completed the down-sizing of the prototype. Approximately 80 recyclers which were to be sold in the Plastics Recycling programs were manufactured in 1981.

The Sentinel EPE Recyclers were simple batch-type machines designed to grind expanded polyethylene foam and film into a densified form called "popcorn" which could be further processed to produce resin pellets suitable for some uses in the plastics industry. In practice, the recyclers chopped up about 100 pounds of scrap per hour. Operation of the recycler was performed by low-wage factory help with minimal training.

The down-sized recycler's component parts consisted of a large drum plastification cylinder, an exhaust blower for removal of volatiles, replaceable rotating and stationary cutting blades, a 40-horsepower motor, a discharge hopper, a control panel, and an opening for manually feeding the scrap.

III. *What Really Happened Under the Framework of the Transaction or Deal*

A. *The Investment, the Partnerships, and the Simultaneous Transfers*

The participants in the Sentinel Recycler leasing programs invested through tiered partnerships in a series of simultaneous transactions. By a private placement memorandum dated November 17, 1981, Clearwater offered subscriptions for 16 limited partnership units at $50,000 per unit. The limited partners owned 99 percent of Clearwater, and the general partner, Winer, owned the remaining 1 percent.

Each limited partner was required to have a minimum net worth exclusive of his principal home, furnishings, and automobiles in the amount of $200,000 per limited partnership unit. In addition, each partner was required to have enough income during the 1981 taxable year to place the limited partner in an income tax bracket of at least 50 percent.

Petitioner received a 16.67-percent interest in the general partnership known as DL and Associates in exchange for his investment of $8,333. DL and Associates owned a 6.188 percent limited partnership interest in Clearwater, which leased six Sentinel EPE Recycler in 1981. The offering memorandum provided the following summary of approximate intended uses of the proceeds from the offering:

RECEIPTS:	Amount	Percentage of Proceeds
Limited partners	$800,000	
General partner	1,000	
	$801,000	100.00

DISBURSEMENTS	Amount	Percentage of Proceeds
Prepaid rent	$605,500	75.59
Commissions/fees	80,000	9.99
General partner's fee	60,000	7.49
Attorney's fee	40,000	5.00
Accountant's fee	2,500	.31
Working capital	13,000	1.62
	$801,000	100.00

Clearwater's private placement offering memorandum informed investors that the business of the partnership would be conducted in accordance with six simultaneous transactions.

The first transaction was the sale by PI of six Sentinel EPE Recyclers to ECI for $5,886,000, of which $416,600 was paid in cash. The balance was to be paid pursuant to the terms of a 12-year nonrecourse note requiring equal monthly installments of $100,917, including annual interest at 19.8 percent with the first payment due 7 months after the closing. ECI's purchase was subject to Clearwater's leasing agreement and FMEC's licensing agreement, as set out below. The interposing of ECI between PI and F & G, a secondary buyer, was consistent with Grant's exclusive arrangement with PI to sell the Sentinel EPE Recyclers and with payment arrangements.

The second transaction involved the sale by ECI of the six recyclers to F & G for $6,976,000, of which $476,233 was paid in cash and the balance paid by a 12-year partial recourse note requiring equal monthly installments of $100,917, including annual interest at 15.4 percent. The note was full recourse against F & G to the extent of 10 percent of its face value and the recourse portion was

payable only after the 90-percent nonrecourse portion was satisfied. The first payment on the note was due 7 months after the closing.

F & G's purchase was subject to Clearwater's agreement to enter into a lease with F & G and was subject to FMEC's agreement to enter into the license as set out below.

In the third transaction, F & G leased the six Sentinel EPE Recyclers to Clearwater for 12 years, a lease term equal to 150 percent of the class life of the assets. Under the lease, the monthly rental payment was $100,917 with an initial amount of $605,500 to be pre-paid at the closing as rental for the first 6 months.

The fourth transaction involved Clearwater's licensing of the six Sentinel EPE Recyclers to FMEC for 12 years at a guaranteed minimum royalty of $100,917 per month beginning with the seventh month of the license plus a prepaid nonrefundable $20,500 advance royalty. After the recyclers were placed in service, the license required additional royalty payments based on a percentage of profits which might be realized on the sale or use of the resin pellets produced from recyclers.

The offering memorandum specifically defined "profits" for the purpose of computing the additional royalty as the sales price of the resin pellets (or their fair market value if used by any sublicensee), less the sum of (1) the scrap recycling fee paid to converters, estimated at 15 cents per pound, and (2) an allowance to sublicensees for transporting and further processing the recycled material, estimated at 15 cents per pound.

In the fifth transaction, FMEC sublicensed the six recyclers to PI, the manufacturer, on a month-to-month basis for a royalty of $100,917 per month. The sublicense to PI was subject to most of the terms of the license from Clearwater to FMEC.

The sixth and final transaction involved the month-to-month sublicense by PI of the recyclers to end-users who would do the actual converting of their thermoplastic foam and film. The terms of the sublicense generally required the end-user to pay to PI 100 percent of the recycled foam or film in exchange for a payment from FMEC based on the quality and amount of recycled scrap. There is no evidence that FMEC ever made payments to end-users although on occasion PI made some payments for scrap produced by end-users. Service and installation costs were to be borne by the end-user. End-users were also required to use their best efforts to recycle 220 pounds an hour for 16 hours per week. Supposedly, only PI was to service or repair the recycler. Neither PI, nor the end-users, carried out the terms of the sublicense faithfully. In practice, those terms regularly were ignored.

The following diagrams illustrate the six simultanteous transfers of the recyclers among the entities involved in the alleged flow of funds. Fees and costs paid out by the various entities to promoters, accountants, lawyers, et al. are not set out specifically in illustration 3. Petitioners claim that a $20,500 advance royalty was paid by FMEC to Clearwater. The record establishes neither the source of such funds nor the actuality of payment.

ILLUSTRATION 2

CLEARWATER TRANSACTION: PATH OF RECYCLERS (POST ERTA)

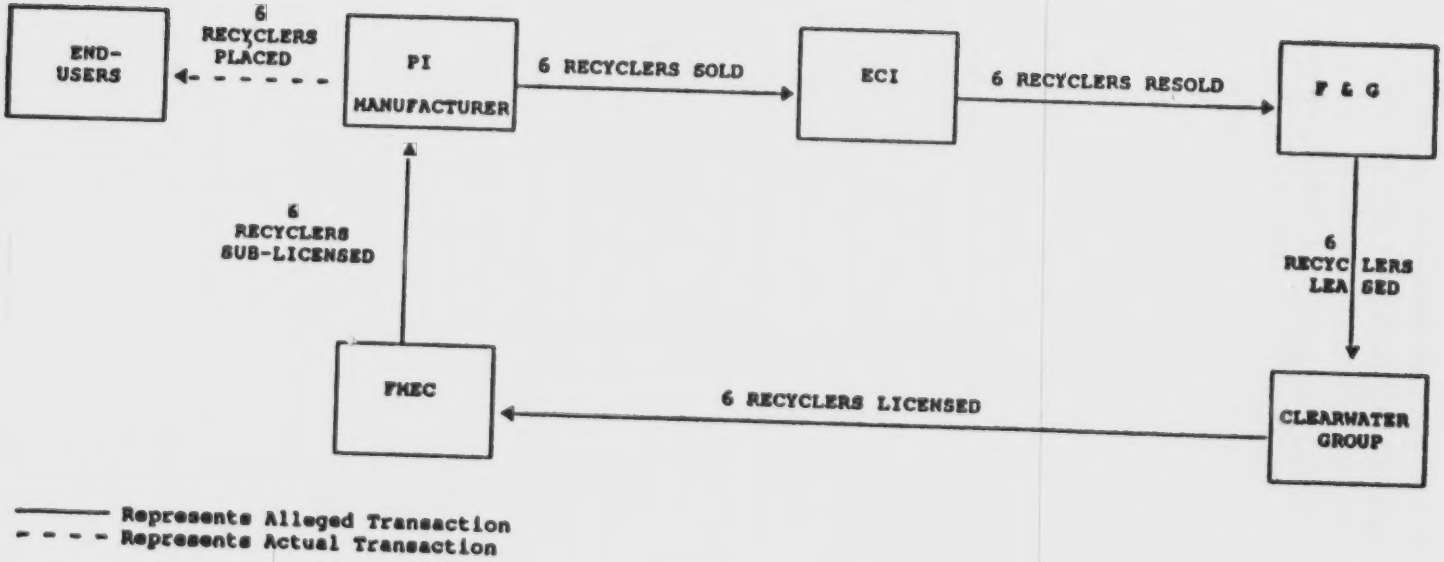
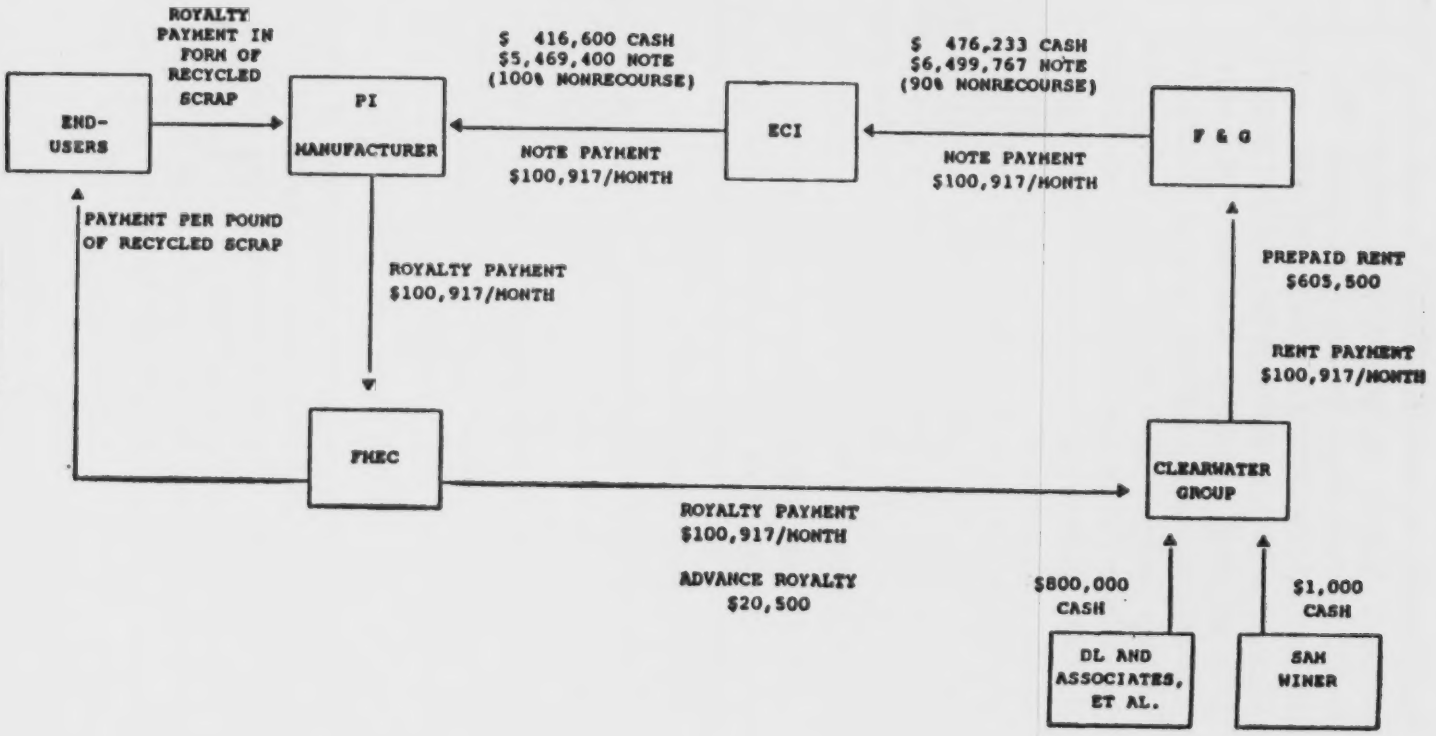


ILLUSTRATION 3

CLEARWATER TRANSACTION: ALLEGED PATH OF THE FLOW OF MONEY



The offering memorandum lists significant business and tax risk factors associated with the investment. Specifically, the offering memorandum states that there was a substantial likelihood of audit by the Internal Revenue Service and that the purchase price paid by F & G to ECI probably would be challenged as being in excess of fair market value; that the partnership had no prior operating history; that the general partner had no prior experience in marketing recycling or similar equipment; that the limited partners had no control over the conduct of the partnership business; that there was no established market for the recyclers; that there could be no assurances that market prices for virgin resin would remain at their current costs per pound, or that the recycled pellets would be as marketable as virgin pellets; and that certain potential conflicts of interest existed.

The offering memorandum also includes a discussion of the tax aspects of the transactions and a tax option prepared by WMDI concerning the tax issues involved in the Plastics Recycling program.

The Clearwater transaction closed on December 21, 1981.

B. *Operation of the Sentinel EPE Recyclers*

The Plastics Recycling programs involved the leasing of Sentinel EPE and EPS recycling machines manufactured by PI. Clearwater leased six Sentinel EPE Recyclers.

The entire recyling process consists of four steps: (1) Collecting low-density polyethylene scrap; (2) grinding the scrap into popcorn; (3) extruding the popcorn to get out the remaining volatiles; and (4) feeding the resulting material through a pelletizer to chop it into pellets. The result of the entire process can be a milky-white uniform pellet of resin if appropriate scrap plastic is collected and fed into the machines.

The process performed by the Sentinel EPE Recycler consists of grinding the polyethylene scrap into popcorn. The scrap is fed manually into the large drum cylinder which contains stationary blades and rotary blades. The rotary blades move at high speeds producing friction which heats the scrap. Once the scrap begins to densify, water may be added to cool and stiffen the material. At times, either no water was used in the process or water was just dumped into the recycler by the paid. The recycled material then is discharged from the machine. The resulting popcorn looks like white crumb of varied size.

At no time were all six of the Sentinel EPE Recyclers, serial numbers 395-81-047 to 395-81-052, leased by Clearwater, placed with end-users. PI's records regarding the six Clearwater recyclers are incomplete and unreliable. From the testimony of end-users, and the evidence provided by PI and its employees, we find that the recyclers were used infrequently and they often were not in use at all. PI failed promptly to pick up either the scrap or machines rejected by prospective end-users, and at times did not pay the end-user for the scrap that PI did pick up.

For example, one of the six recyclers bought by Clearwater was placed with four different end-users in 4 years. The first end-user was Olympic Spa Covers, Inc., which refused to accept delivery of the recycler. The second end-user was Great Western Foam, which found the recycler to be too clostly and noisy. PI took 6 months to pick up the recycler after PI was notified that Great Western Foam no longer wanted the recycler. The third end-user, Midco Packaging, ran a cost/benefit analysis on the recycler and found it unprofitable. PI waited another 6 months before picking up the recycler. Spokane Packaging, the last end-user to have the machine, used it infrequently and was not paid for the recycled scrap produced.

IV. *Machines for Recycling Plastic Which Were Available on the Open Market in 1981*

The following recycling machines were commercially available during the year at issue:

A. *Buss-Condux Plastcompactor*

The Buss-Condux Plastcompactor (Plastcompactor) was advertised in trade journals during 1981 and was described as a machine capable of transforming foam into free-flowing, densified granulate suitable for processing. The Plastcompactor process was advertised as continuous plastification and densification between two disks—one rotating, the other stationary, in a water-free operation and without product degradation.

The Plastcompactor is manufactured in two sizes, the CV30, which processes about 300 pounds per hour of polyethylene foam and the CV50, which processes about 700 pounds per hour of foam. These machines were available in 1981 at respective prices of approximately $90,000 and $180,000.

B. *Nelmor/Weiss Densification System (Regenolux)*

The Nelmor/Weiss Regenolux is a batch-type machine which densifies materials including low-density polyethlene foam scrap. The Regenolux uses roating blades which cut the scrap material and creates frictional heat. As the temperature of the scrap increases, the material softens. Water mist cools and solidifies the material to form uniform densified particles.

The Regenolux RL-450 was advertised for sale and was commercially available at a selling price of $38,000 in 1981. The Regenolux can process scrap at rapid rates.

C. *Cumberland Granulators*

Cumberland Engineering, a division of John Brown and Co., and associated companies manufactured a complete

line of recycling equipment including grinders, extruders, and pelletizers. The entire system of components was available for less than $200.000.

D. *Foremost Densilator*

The Densilator is a machine available since 1978 from Foremost Machine Builders, Inc. Although the Densilator was marketed for the reclaiming of polyethylene film, the Densilator process is similar to that of the Sentinel EPE Recycler. The Densilator shreds the scrap with a rotary blade and converts the material to a mass by the heat produced by the shredding. The Foremost machine sold in 1981 for approximately $20,000.

V. *Expert Opinions*

Both parties offered expert testimony concerning the value of the recycling equipment and the value associated with the alleged obligation of PI to install, maintain, and insure the equipment. These experts largely disagree.

A. *Petitioners' Experts*

1. *Donald N. Merino*

Donald N. Merino (Merino) is a professor of management at Stevens Institute of Technology. He holds a Ph.D. in managerial economics and his undergraduate training is in engineering. Merino submitted a report and testified as to the economics of the transaction and the value of the Sentinel EPE Recycler. Merino also is an investor in another Plastics Recycling program. Merino invested $24,000 in Northeast Resource Recovery Associates. As a result of this investment, Merino claimed on his 1981 income tax return $36,000 of tax credits and $19,526.16 of partnership losses.

Merino's entire report is based on the assumption that the Sentinel EPE Recycler is a unique product for which there is no competition so that PI holds a monopoly on

a product needed by others. Merino's report is divided into three parts.

The first part of Merino's report includes a discussion of economic principles and the method he used to value the Sentinel EPE Recycler, i.e., an after tax cash-flow basis discounted for the time value of money to determine the internal rate of return (IRR).

The IRR is defined as a rate of return calculated to take into account only the cash receipts and disbursements generated by an investment, their timing, and the time value of money.

Generally, if the IRR is equal to a project's rate for cost of capital, the project will break even. If the IRR is greater than the rate for cost of capital, then the project is presumed to be financially profitable. Conversely, if the IRR is less than the rate for cost of capital, the project is presumed to be unprofitable.

Merino also calculated the Minimum Attractive Rate of Return (MARR). MARR is the effective annual rate of return on investment, either before or after taxes, which just meets the investor's threshold of acceptability. Merino stated that the appropriate MARR used for investment in new equipment varies between 10 percent and 15 percent per annum after tax. Merino explained that if the IRR is greater than the MARR, then the project is acceptable.

The second part of Merino's report evaluated the recycler at the time of the Clearwater offering from the viewpoint of investors and end-users. Merino concluded that the sale of a recycler at $1,162,666 would yield an IRR of approximately 12 percent per annum which, when compared to a MARR of 10 percent, would make the investment economically acceptable from an investor's point of view. Merino performed a similar calculation for end-users and concluded that they would also find the project to be economically acceptable. The last part of

Merino's report evaluated the recycler's price based on a visit to Rempac, where a Sentinel EPE Recycler had been placed for use. Merino alleged that a Rempac representative advise him that popcorn scrap then was being sold by Rempac to an extrusion processor for 20 cents per pound and that the machine was in use at Rempac several days each week and processed 200 to 300 pounds per hour. On these assumptions, among others, Merino again calculated that the project would yield an IRR that was greater than the user's MARR, making the project economically acceptable. The testimony of Rempac officers establishes that Merino's assumptions about Rempac usage are faulty in several respects. Rempac did not sell popcorn for 20 cents per pound and sold only to PI. At Rempac, the machine was operated only 1 day per week and produced only 100 pounds per hour.

Merino's assumptions concerning the value of popcorn scrap and virgin resin are high and he overstates the value of the recycled product compared to virgin resin. Moreover, in his calculations, Merino undertsates other cost factors such as electricity and fails to consider adequately the cost of additional processes of extruding and pelletizing which are necessary to bring the recycled material to a stage where it can be sold in the market for resin pellets.

2. *James D. Fogarty*

Petitioners' second valuation witness, James D. Fogarty (Fogarty), is president of Plastic Engineering Associates, Inc., and has extensive experience in the plastics industry. Fogarty submitted a report and testified as to value based on trade literature available in 1981 and his visit in October of 1986 to Hyannis where he viewed a Sentinel EPE Recycler in operation. In his report, Fogarty concluded that a fair market value of $1,162,667 was justified solely on the basis of the Sentinel EPE Recycler being the only machine during 1981 capable of recycling low-density expanded polyethylene foam, again an

assumption of a monopoly position. He stated that the blades on the outer cylinder of the recycler and the way the recycler removed the volatiles from the scrap made the Sentinel EPE Recycler unique.

3. *Robert F. Staats-Westover and Leonard Sansone*

Robert F. Staats-Westover (Staats-Westover) is the manager of the New Jersey Polymer Extension Center at Stevens Institute of Technology and an adjunct professor of chemical engineering who submitted an expert report. Leonard Sansone (Sansone) is the president of Sussex Plastics Engineering Inc., and an engineer/consultant who coauthored the report submitted by Staats-Westover. They testified as to the value of the recycler, the economics of the transaction, and the price of resin during the year in issue.

The Sansone/Staats-Westover report includes a conclusion that the Sentinel EPE Recycler was a unique and successful commercial recycling machine capable of densifying low-density polyethylene foam to rigid granular feed stock at a rate of 200 to 300 pounds per hour. It is the opinion of the authors of this report that $1,162,666 was a reasonable price given a rate of return exceeding 10 percent. That conclusion was based on a review of the economic calculations provided by Merino and a visit to Rempac where a Sentinel EPE Recycler was in operation and where recycled pellets were allegedly being sold for 20 cents per pound to an extrusion processor. As we have noted, that assumption plainly was incorrect. They also reviewed Merino's report and found it to be accurate, provided the recycler actually was unique. Their conclusion that the recycler was unique was based on Merino's findings and was not independently confirmed.

4. *Albert Spaak*

Albert Spaak (Spaak) testified as to the value of the recyclers and the economics of the Plactics Recycling

transaction. Spaak submitted a written report which purported to verify that the Sentinel EPE Recycler was the only commercial equipment capable of recycling low-density polyethylene foam during 1981. Spaak considered the product and the Sentinel EPE Recycler's method of cutting to be unique and thought of PI's arrangement as a monopoly. He reviewed Merino's report and found Merino's numbers "to be conservative and reasonable." Spaak also reviewed Fogarty's report and agreed with its conclusions. He did not personally view or inspect a Sentinel EPE Recycler in operation. His opinion was based primarily on photographs of the machine and conversations with other experts.

On cross-examination, Spaak said that other companies had found various ways to reclaim scrap. His report included a comment that PI's competitors had "found ingenious ways to handle their scrap."

5. *Samuel Z. Burstein and Stanley Ulanoff*

Samuel Z. Burstein (Burstein) and Stanley Ulanoff (Ulanoff), the "F & G evaluators," provided reports which were part of the Clearwater offering memorandum. They did not appear to testify in support of their reports in this case and so avoided cross-examination as to the basis for their conclusions.

Ulanoff is a professor of marketing at Baruch College who has authored numerous books on technical and marketing subjects. His report covered the marketing value and potential of the recyclers and expressed the conclusion that the sales price paid by F & G for the recyclers and the rental payment made by Clearwater were fair and reasonable. His conclusion allegedly was based on his personal observation of the Sentinel EPE Recycler prototype during a visit to PI, discussions with PI employees, the needs of the plastics industry, and his analysis of the economic projections provided in the offering memorandum.

Burstein is an associate professor of mathematics at New York University. Allegedly based on his visit to PI, discussions with PI personnel, an evaluation of the technical value of the recycler, the recycler's history of performance, and information concerning the use of recycled polyethylene as a raw material, Burstein concluded that the Sentinel EPE Recycler was capable of recycling on a continuous basis.

B. *Respondent's Experts*

1. *Garth Saloner and Janusz Ordover*

Garth Saloner (Saloner) and Janusz Ordover (Ordover) coauthored a report, the purpose of which was to estimate the value of the Sentinel EPE Recycler to a potential purchaser. Saloner is an associate professor of economics and management at Massachusetts Institute of Technology. He gave expert testimony regarding the economic potential of the Plastics Recycling programs. Ordover is a professor of economics at New York University.

In their report, Saloner and Ordover concluded that using very favorable economic assumptions and the net present value (NPV) method, the value of the recycler at the time of the Clearwater offering was between $37,000 and $68,000, depending on the useful life of the recycler. The NPV method is based on a projection of revenue and cost flows as well as savings achieved (by eliminating the cost of waste disposal). Adjustments were made for inflation and the time value of money.

2. *Steven Grossman*

Steven Grossman (Grossman) is an assistant professor in the Plastics Engineering Department at the University of Lowell. He gave expert testimony regarding the limited market for the recycled plastic material and submitted a report. Grossman concluded that the Sentinel EPE Recycler was unlikely to be a successful product because of

the absence of any new technology, the absence of a continuous source of suitable scrap, and the absence of any established market. Grossman suggested that a reasonable comparison of the products available in the polyethylene industry in 1981 with the Sentinel EPE Recycler would reveal that the Sentinel EPE Recycler had very little commercial value and was little different from other products available on the market in component form.

Grossman's opinion regarding the Sentinel EPE Recycler was based on the descriptions of the Sentinel EPE Recycler given in other experts' reports and the offering memorandum. He neither tested nor examined the Sentinel EPE Recycler or any of the other commercially available machines.

3. *Richard S. Lindstrom*

Richard S. Lindstrom (Lindstrom) of Arthur D. Little, Inc., a consultant with more than 30 years of experience with plastics and plastics equipment, submitted a report in conjunction with his expert testimony regarding the value of the recyclers. In his report, he determined that several different types of equipment capable of recycling expanded polyethylene were available and priced at approximately $50,000 in 1981. Although Lindstrom initially was prevented from closely examining the recycler, based on his later observations of the Sentinel EPE Recycler in operation, Lindstrom estimated the manufacturing cost of the Sentinel EPE Recycler to be approximately $20,000. Before trial, but subsequent to completion of his report, Lindstrom was allowed to inspect another Sentinel Recycler closely at another location, to take photographs of the recycler, and to look at blueprints for the recycler.

ULTIMATE FINDINGS OF FACT

1. The fair market value of a Sentinel EPE Recycler during 1981 was not in excess of $50,000.

2. The Clearwater limited partner transaction lacked economic substance since the Clearwater partnership had no net equity value and since the only activity with which Clearwater was involved lacked any potential for profit.

3. Petitioners' objective in investing in the Sentinel EPE Recycler leasing program was to gain a significant tax advantage and not to earn an economic profit.

OPINION

I. *Preliminary Matters*

Petitioners' position in this case is that the series of transactions involved in the Plastics Recycling programs should be considered effective for tax purposes regardless of whether the entire deal was a sham. Petitioners contend that the purpose of the safe-harbor provisions is to allow the transfer of tax benefits, and if a lease meets all of the statutory requirements of section 168(f)(8), the transaction is to be treated as a lease without considering any other factors. Alternatively, petitioners argue that even if a sham testing is applicable, the transactions should be treated as valid business activities for tax purposes because they presented a significant and realistic possibility of profit, had economic substance, and were motivated by valid business purposes.

Respondent argues that the safe-harbor leasing rules of section 168(f)(8) do not prevent the application of the sham in substance test to a series of transactions of which a safe-harbor lease is just a part. Respondent's position is that the lease is a part of a tax-avoidance scheme and that the entire transaction should be disregarded for Federal income tax purposes.

In *Greene v. Commissioner,* 88 T.C. 376, 382-383 (1987), this Court decided that there is nothing in the legislative history of the safe-harbor leasing rules which indicates that such a lease can be isolated as a matter

of law from the transactions which surround it for the purpose of making the sham transaction doctrine inapplicable to the entire transaction. Petitioners have urged a review of the rule set forth in the *Greene* opinion, but we adhere to and follow that opinion. In *Greene v. Commissioner, supra* at 383, this Court invited the taxpayers "to persuade us that the lease in fact should be so isolated and that their claim to the benefits of section 168(f)(8) is otherwise valid." We have not been so persuaded by petitioners here, but instead, we find that in fact the purported safe-harbor lease was merely one segment of a chain of carefully planned, interdependent transactions in a single program. The traditional sham transaction doctrine is applicable to the integrated series of transactions involved in the Plastics Recycling program.

In the notice of deficiency in this case, respondent disallowed all the claimed deductions and credits relating to petitioners' Plastics Recycling investment. Respondent's determination is presumptively correct and petitioners bear the burden of proof on all pertinent items. Rule 142(a); see *Welch v. Helvering,* 290 U.S. 111 (1933).

II. *The Transaction or Deal in Issue Here is a Sham*

The principal question for consideration here is whether the transaction, into which the supposed safe-harbor lease was integrated, was a sham.

In general, a transaction will not be considered a sham where there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached. *Frank Lyon Co. v. United States,* 435 U.S. 561, 584-585 (1978).

Taxpayers are free to structure their business transactions as they wish, even if they are motivated by tax-

avoidance considerations, provided a nontax or business purpose also is present. *Knetsch v. United States,* 364 U.S. 361, 365-366 (1960); *Gregory v. Helvering,* 293 U.S. 465, 469 (1935).

In applying these basic rules in more recent cases involving the question of whether a purported business transaction is a sham, we have first inquired whether the transactions were factual shams designed and carried out for tax avoidance. See, e.g., *Freytag v. Commissioner,* 89 T.C. 849, 876-877 (1987), affd. 904 F.2d 1011 (5th Cir. 1990), affd. on another issue 501 U.S. ——, 59 U.S.L.W. 4872 (June 27, 1991). If such transactions existed in fact, the question is whether such transactions, nevertheless, amount to a sham in substance.

In the present case, respondent has introduced expert testimony to the effect that the market value of the Sentinel EPE Recycler during year in issue may have been negligible and evidence that end-users found the machine of little or no value. Respondent also has introduced and relied upon credible expert testimony that the recycling machine in issue is similar to others actually on the market and might properly be valued as high as $50,000. Accordingly, in our view for purposes of this case only, respondent effectively has conceded that the Clearwater transaction is not a factual sham. Respondent plainly has not conceded that the Clearwater transactions have sufficient economic substance to support the tax results claimed by petitioners. Respondent's contention is that the transaction in issue is a sham in substance.

This Court has defined "sham in substance" as "the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits." *Falsetti v. Commissioner,* 85 T.C. 332, 347 (1985). In essence, a sham in substance exists when a series of transactions actually takes place, but has no business or profit-making function other than the obtaining of tax benefits.

As applied in *Rice's Toyota World, Inc. v. Commissioner,* 752 F.2d 89 (4th Cir. 1985), affg. in part and revg. in part 81 T.C. 184 (1983), the sham in substance test is a two-prong test which is met if either the economic substance test or the business purpose test can be satisfied. The business purpose test focuses on the investor's subjective purpose for entering the transaction while the economic substance test focuses on the objective factors indicating whether there was a reasonable opportunity to make a profit exclusive of tax benefits. *Rice's Toyota World, Inc. v. Commissioner, supra.*

Although we are not required to adopt a rigid two-prong subjective/objective test, in our view economic substance and business purpose are relevant inquiries to consider in applying the traditional sham analysis. *Shriver v. Commissioner,* 899 F.2d 724 (8th Cir. 1990), affg. T.C. Memo. 1987-626; *Sochin v. Commissioner,* 843 F.2d 351, 354 (9th Cir. 1988), affg. *Brown v. Commissioner,* 85 T.C. 968 (1985); *Cherin v. Commissioner,* 89 T.C. 986 (1987).

In *Rose v. Commissioner,* 88 T.C. 386 (1987) affd. 868 F.2d 851 (6th Cir. 1989), this Court stated a modified approach to evaluating tax shelter cases. In doing so, the Court identified the uniform characteristics of a "generic tax shelter." Regardless of how the test is labeled, the underlying determination to be made is whether the transaction had an economic effect other than the creation of tax losses. *Rose v. Commissioner,* 868 F.2d at 854. In this case, appeal from our decision would lie with the Court of Appeals for the Sixth Circuit, the Court which reviewed the *Rose* case. This Court will follow a Court of Appeals decision which is squarely on point where appeal from our decision lies in that Court. *Golsen v. Commissioner,* 54 T.C. 742 (1970), affd. on another issue, 445 F.2d 985 (10th Cir. 1971). Although the Sixth Circuit affirmed our holding in the *Rose* case, it declined to adopt

the generic tax shelter analysis. *Rose v. Commissioner, supra* at 853-854. Accordingly, we have not pursued that analysis but instead consider whether there was any economic substance or business purpose in these transactions. We do not consider whether, in light of hindsight, the taxpayer made a wise investment, but rather whether he made any bona fide investment at all or merely purchased tax deductions. *Bryant v. Commissioner,* 928 F.2d 745, 749 (6th Cir. 1991).

A. *The Deal Lacks Economic Substance*

Petitioner argues that the form of the Plastics Recycling program should be upheld under the economic substance test since Clearwater conducted an activity that had the potential for substantial profit. Petitioner relies in part on expert testimony to establish the value of the Sentinel EPE Recyclers, the economics of the transaction, and the price of virgin resin in 1981.

Respondent argues that the recyclers were grossly overvalued and that the transaction lacked economic substance. Respondent contends that based on the testimony and economic calculations of experts, the Sentinel EPE Recycler had a maximum value of $30,000.

The economic substance test is based on objective factors which indicate whether the taxpayer acquired an equity interest in the property and whether he had a reasonable opportunity for economic success. In *Levy v. Commissioner,* 91 T.C. 838, 856 (1988); we found the following factors to be particularly important: The presence or absence of arm's-length price negotiations, *Helba v. Commissioner,* 87 T.C. 983, 1005-1007 (1986), affd. 860 F.2d 1075 (3d Cir. 1988); the relationship between the sales price and fair market value, *Zirker v. Commissioner,* 87 T.C. 970, 976 (1986); the structure of the financing, *Helba v. Commissioner, supra* at 1007-1011; the degree of adherence to contractual terms, *id.* at 1011;

and the reasonableness of the income projections, *Rice's Toyota World, Inc. v. Commissioner, supra* at 204-07.

1. *Equity Interest*

One aspect of the economic substance test focuses on whether the buyer/lessor has obtained an equity interest in the equipment purchased. A meaningful equity interest in the property may be established by a payment in cash or by personal liability on a recourse debt. *Estate of Franklin v. Commissioner,* 544 F.2d 1045 (9th Cir. 1976). In *Estate of Franklin v. Commissioner, supra,* at 1048-1049, the Court of Appeals for the Ninth Circuit found that if a purchase price substantially exceeds the fair market value of property and the purchase is financed almost entirely with nonrecourse indebtedness, then payments on the debt do not result in equity because by abandoning the transaction the buyer would lose no more than the chance to acquire future equity if the property value actually increases.

To apply this test, we first must determine the fair market value of the Sentinel EPE Recycler. The standard for measuring fair market value is the price at which the property would change hands between a hypothetical willing buyer and seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. *United States v. Cartwright,* 411 U.S. 546, 551 (1973). Fair market value is inherently a question of fact to be resolved by weighing all the relevant evidence in the record and drawing appropriate inferences therefrom. *Estate of Gilford v. Commissioner,* 88 T.C. 38, 50 (1987).

The record is devoid of any factual data regarding the actual costs of producing a Sentinel EPE Recycler. PI kept no records of the research and development costs incurred by the foam division in developing the prototype. The record in this case does not include any evidence of the costs of manufacturing the scaled-down recyclers kept

by the machinery division. The $1 million price Bambara supposedly set for the Sentinel EPE Recycler, allegedly based on a pricing policy which PI regarded as a "trade secret", had nothing to do with costs because PI had no cost accounting system or records. This supposed price tag had nothing to do with traditional supply and demand pricing since the product never was offered on the open market and there is no evidence that anyone ever intended that it would be so offered.

We are not convinced that Bambara actually expected to receive more than the initial cash payment. The rest of the supposed purchase price was mere window dressing used to disguise a series of offsetting payments only realized in the form of bookkeeping entries.

To establish the fair market value of the recycler, petitioner and respondent presented the testimony of numerous experts. Opinions of experts are not binding on this Court and may be rejected entirely if contrary to our judgment. *Helvering v. National Grocery Co.*, 304 U.S. 282 (1938); *Laureys v. Commissioner*, 92 T.C. 101, 122-129 (1989); *Chiu v. Commissioner*, 84 T.C. 722, 734 (1985).

Merino, petitioners' key valuation witness found that the Sentinel EPE Recycler was worth at least the purchase price based on a calculation using the IRR method. Merino's valuation was based on the assumption that PI had a monopoly position with respect to a product for which there was a substantial market. We have found from the substantial evidence presented by respondent that PI did not have a monopoly but was entering a market in which there were competitive machines. We also have found that in that market place the PI product's value was not in excess of $50,000. Since Merino's testimony is based on a false premise and since Merino himself invested a substantial amount in a Plastics Recycling program and testified more in the manner of an advocate or an interested party than a disinterested expert in giving his opinion, we find his testimony to be self-serving, unpersuasive, and of little

or no value. *Wood v. Commissioner,* 338 F.2d 602, 605 (9th Cir. 1964), affg. 41 T.C. 593 (1964).

Fogarty, another of petitioners' valuation witnesses, also claimed that the nominal selling price was reasonable. Fogarty's opinion was based on his belief that no other product on the market in 1981 was capable of recycling low-density polyethylene. Since we have found as a fact that there were commercially available machines which were capable of performing the same process as the Sentinel EPE Recycler, we consider Fogarty's opinion also of little or no value.

We note that Fogarty asserted that the Sentinel EPE Recycler was unique because of the blades on the outer portion of the cylinder of the recycler and the way the recycler removed the volatiles from the scrap. Spaak explained: "The uniqueness is the method of cutting the foam material." Another vague suggestion of uniqueness concerned the cooling process. The offering memorandum explanation of the operation of the EPE recyclers states: "After further purification, the densified mass is then cooled through the latent heat of vaporization of *injected fluid mixed with chemical compounds regarded by PI as trade secrets.*" (Emphasis added.) Petitioners' tax counsel, admittedly no engineer, testified that the EPE Recycler was unique because:

> they had some fluid that they regarded as a trade secret that got injected that had the effect of enabling them to take out the gas and vent that off and, at the same time, taking the plastic and turn it back into something that is called 'popcorn', which was pure plastic, which could then be converted into pellets in a fairly simple process and, in effect, could be utilized again, just as it had been virgin material.

Strzelewicz, who supervised development of PI's prototype recycler, explained that the coolant used in the process was plain water and not some "trade secret" chemical

compound. End-users stated that a usual method by which the water might be "injected" was for a factory worker to dump it on the heated material. Repeatedly, petitioners' witnesses failed to identify adequately any unique aspect of the EPE Recycler to explain the immensely inflated value claimed for the unit.

The testimony and report by Sansone and Staats-Westover is similarly flawed, in that they also based their opinion on the calculations performed by Merino without independently verifying the results. Moreover, their results presumed the Sentinel EPE Recycler actually was unique.

We are unconvinced by the opinion of Spaak, who also found the selling price to be reasonable. He based his opinion on the descriptions and calculations of other experts without independently verifying the basis for his conclusion. Essentially, he merely made a survey of various out-of-Court materials and relied heavily on the Merino report. Moreover, although Spaak testified that the Sentinel EPE Recycler was unique, he also admitted at trial that PI's competitors had found "ingenious" ways of recycling foam.

Petitioner's reliance on his experts as well as the F & G evaluators is misplaced. Petitioner supposedly relied on the marketing opinion of Ulanoff and the technical opinion of Burstein included in the offering memorandum. Except for the date, duplicates of these documents were included in every private offering memoranda relating to the Plastics Recycling programs.

Ulanoff was hired by F & G at the suggestion of Grant, the sole owner of ECI. Ulanoff and Burstein each owned an interest in more than one partnership which owned Sentinel Recyclers as part of the Plastics Recycling program. The reports prepared by Ulanoff and Burstein concluded that the transaction was feasible from a technical and marketing standpoint and that the price paid to ECI was fair and reasonable. Ulanoff and Burstein did

not testify at the trial of this case and we consider their reports of no significant value.

Respondent's valuation witness, Saloner, used the NPV method to calculate the value of the recycler at $37,000 to $42,000. Respondent's technical expert, Grossman, found the recycler to be almost valueless. He based his conclusion on a comparison of the recycler with the other products available for thermoplastic scrap recycling that were similar in design and construction to the Sentinel EPE Recycler.

Lindstrom, a valuation witness for respondent, also based his evaluation on a comparison between the Sentinel EPE Recycler and the other commercially available machines. Lindstrom estimated the market value of the Sentinel EPE Recycler at approximately $50,000 and estimated the manufacturing cost to be in the range of $20,000.

Lindstrom's statements of his opinion and the basis for it were reasonable and persuasive, and we have relied heavily on his expert report and testimony in making our finding of fact as to valuation. As for Sansone, Staats-Westover, and Spaak, they based their opinions on data given to them by Merino. Lindstrom came to his conclusion based on a survey of competing machines and his personal observation of the machines.

Respondent's expert Saloner used the NPV method and valued the recycler at a maximum of $42,000. Petitioner's expert Merino used the IRR method and valued the recycler at the selling price. The variations in valuations are based on dramatic differences in the assumptions made by each of the experts, including differences regarding the resale price of the recycled material, the quantity of recycled material the recycler is capable of producing, and the quantity of available scrap to be recycled. Obviously, whether the leased Sentinel EPE Recyclers generate a positive or negative discounted cash-flow to the investor depends on whose assumptions are more accurate.

Merino's assumptions as to the pricing and value of virgin pellets and as to the value of the popcorn produced by the Sentinel EPE Recycler and the price of pellets were flawed. His assumptions as to the productivity of the Sentinel EPE Recycler were contrary to the testimony of an officer of Rempac, the very end-user from whom he supposedly obtained information. Most important, Merino assumed a monopoly which we have found non-existent.

Moreover, we have already determined that Merino's opinion is of questionable reliability or value because of his personal financial interest in the outcome of this case.

We have found Lindstrom's conclusions persuasive and determined the value of the Sentinel EPE Recycler to be not in excess of $50,000. The purchase price of $1,162,666 is inflated by more than 23 times its actual value. This determination is buttressed by the fact that the recyclers were only insured by PI for $55,000 per machine with a $25,000 deductible per machine and by respondent's experts' testimony and a comparison with other machines which were commercially available in 1981.

In the present case, F & G had no reason to anticipate a profit in the foreseeable future. The structure of the financing was such that approximately 83 percent of the purchase price was financed using nonrecourse notes. Moreover, the recourse portion of the notes was not payable until the nonrecourse portion was satisfied. F & G's equity is limited to the fair market value of the recycler. Any additional amounts paid for the recyclers in excess of the fair market value are not considered equity. *Estate of Franklin v. Commissioner,* 544 F.2d 1045 (9th Cir. 1976).

Petitioner alleges that Bambara unilaterally decided what price would be paid for the recyclers and based that price on PI's pricing policies which were a "trade secret". Petitioner also asserts that at the insistence of PI's au-

ditors, Bambara decided to use nonrecourse financing in the transaction. There is no reliable evidence to support this claim. Instead, the record shows that a grossly inflated purchase price which has on relationship to fair market value was conjured up to maximize the available deductions and credits. See *Zirker v. Commissioner,* 87 T.C. 970 (1986).

Winer, as general partner of Clearwater, did not enter into arm's-length negotiation of the terms of the lease with F & G. Neither did F & G enter into an arm's-length negotiation with ECI, despite the self-serving testimony of Grant, who would have us believe that he negotiated the sales price with Freedman, his personal accountant, business associate, and consultant.

The manner in which the transaction was structured, the lack of arm's-length dealings, and the discrepancy between the fair market value and purchase price on which the pass-throughs were based show the true nature of these transactions. *Beck v. Commissioner,* 85 T.C. 557, 577-578 (1985); *Flowers v. Commissioner,* 80 T.C. 914 (1983).

2. *Opportunity for Economic Success*

The opportunity for economic success is illustrative of economic substance and generally refers to the chances of making a profit in addition to tax savings. *Frank Lyon v. United States,* 435 U.S. 561 (1978). The contractual terms and the reasonableness of the income projections are of importance in evaluating the opportunity for success.

The record here includes contract terms which were designed to allow petitioners to obtain tax benefits with minimal exposure to business risk. In the Clearwater offering, the sale to ECI, the resale to F & G, the leasing to Clearwater, the licensing to FMEC, and the sublicensing to PI, the original purported transfers occurred on

the same day. Each entity allegedly made and received monthly payments in the amount of $100,917.

The price of the six Sentinel EPE Recyclers here in question to F & G was $6,976,000, including $476,233 in cash and a partial nonrecourse note equivalent to the balance. The note required payment of equal monthly installments of $100,917 to maturity. The transaction provided for Clearwater contemporaneously to license the recyclers to FMEC for 12 years at $100,917 per month, plus a lump-sum payment equivalent to 7 months' rent. In accordance with the plan, FMEC was to receive a monthly royalty payment in the same amount from PI which also was to receive the same amount from ECI. All of the entities involved in the transactions purportedly entered into "offset agreements" so that the monthly payments of $100,917 were bookkeeping entries only. In effect, no income was reecived or expected beyond the initial payments. There is no credible evidence showing that monthly rental payments were ever made to F & G and Clearwater had virtually no obligation to pay anything further.

The actions of petitioners and their associates with regard to their investments corroborate the lack of profit objective. Projections set forth in the prospectus were not reasonably relied on. Despite clear indications that PI was not aggressively seeking to place or properly managing the recyclers, petitioners did little to safeguard their investment. They only made a few indirect half-hearted inquiries. Petitioner was not even aware of where the recyclers were installed. Rather, petitioner had substantial income and was aware that the Plastics Recycling programs were tax shelters designed to attract investors looking for tax savings.

The offering memorandum and other documents evidencing the labyrinthine transactions here in issue demonstrate the very high level of expertise, ingenuity, and sophistication of the individuals who devised the Plastics

Recycling transactions. Nevertheless, after considering the lack of any real equity interest in the recyclers for petitioner and other limited partners, and the lack of a genuine opportunity for the partnership to have any economic success, we conclude that the 1981 Plastics Recycling programs lacked economic substance.

B. *The Deal Lacks Business Purpose*

The second prong of the sham in substance test requires a business purpose other than tax benefits. *Rice's Toyota World, Inc. v. Commissioner,* 752 F.2d 89 (4th Cir. 1985), affg. in part and revg. in part 81 T.C. 184 (1983); *Rose v. Commissioner,* 88 T.C. 386, 412-413 (1987), affd. 868 F.2d 851 (6th Cir. 1989).

Petitioners were nonuser recipients of tax benefits as a result of the sale and leaseback of the recycling equipment. A nonuser recipient of tax benefits in a sale and leaseback context must specifically establish that he entered into the transaction motivated by a business purpose sufficient to justify the form of the transaction. *Levy v. Commissioner,* 91 T.C. 838, 854 (1988); *Larsen v. Commissioner,* 89 T.C. 1229, 1252 (1987), affd. in part and revd. in part sub nom. *Casebeer v. Commissioner,* 909 F.2d 1360 (9th Cir. 1990).

A determination of profit objective can be made with reference to the actions of those individuals who manage the affairs of the partnership. *Fox v. Commissioner,* 80 T.C. 972, 1007-1008 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. *Barnard v. Commissioner,* 731 F.2d 230 (4th Cir. 1984), affd. without published opinion sub nom. *Zemel v. Commissioner,* 734 F.2d 9 (3d Cir. 1984), affd. without published opinion sub nom. *Kratsa v. Commissioner,* 734 F.2d 6 (3d Cir. 1984), affd. without published opinion sub nom. *Leffel v. Commissioner,* 734 F.2d 6 (3d Cir. 1984), affd. without published opinion sub nom. *Hook v. Commissioner,* 734 F.2d 5 (3d Cir. 1984).

The burden of proving such objective is on petitioners. Rule 142(a); *Welch v. Helvering,* 290 U.S. 111 (1933). Greater weight is given to objective facts than to a taxpayer's statement of intent. *Thomas v. Commissioner,* 84 T.C. 1244, 1269 (1985), affd. 792 F.2d 1256 (4th Cir. 1986); sec. 1.183-2(a), Income Tax Regs.

The six machines leased by Clearwater's partnership had a total reported cost of over $6,600.000. None of these six machines were shipped to an end-used by the end of 1981. Two of the six machines never worked and remained for most of 1981 through 1985 in a PI warehouse. One machine was sent unsolicited to a company which refused to take the machine and immediately returned the invoice to PI.

Clearwater did not purchase insurance to protect the partners from their liability for any loss to recyclers purportedly worth approximately $6 million. PI insured the recyclers against all risks of loss, damage, or destruction, and that coverage was only for $55,000 per machine, with a $25,000 deductible per machine.

The focus of promotional material distributed to prospective investors is a significant indication of the objective of those who choose to invest. *Friedman v. Commissioner,* 869 F.2d 785, 793 (4th Cir. 1989), affg. *Glass v. Commissioner,* 87 T.C. 1087 (1986). Offering materials which focus on tax benefits and do not provide a sound basis for a profitable operation are indicative of a lack of profit objective. *Beck v. Commissioner,* 85 T.C. 557, 571 (1985); *Seaman v. Commissioner,* 84 T.C. 564, 590 (1985). According to the Clearwater offering memorandum, the projected benefits for each $50,000 investor were investment tax credits in 1981 of $86,238 plus deductions in 1981 of $39,399.

In addition to the foregoing factors, in other leasing cases we have examined, the discounted cash-flow to the investor is evidence of economic profit objective. *Soriano*

v. Commissioner, 90 T.C. 44 (1988). The first question is whether petitioner's leasing activity could possibly have produced a positive discounted cash-flow.

Petitioner argues that the Plastics Recycling programs were economically viable. Respondent argues that the Plastics Recycling programs never could produce a positive discounted cash-flow because the promoters placed the equipment with end-users who generated too little scrap ever to pay off the notes on the machines. Respondent's economic experts testified that using the same discounted cash-flow analysis found in the *Soriano* case, the Sentinel EPE Recyclers had a value in 1981 of a maximum of $50,000 and a minimum of zero.

Since petitioner's economic expert Merino, as well as the F & G evaluators Burstein and Ulanoff, were investors in the Plastics Recycling programs, we consider their conclusions regarding the recyclers to be unreliable. *Wood v. Commissioner*, 338 F.2d 602, 605 (9th Cir. 1964), affg. 41 T.C. 593 (1964). In addition, we give less weight to the complex calculations of petitioner's experts when a comparable product is widely available and its price is known.

Respondent's economic experts, Saloner of the Massachusetts Institution of Technology and Grossman of the University of Lowell, gave their expert opinions regarding the economic potential of the Plastics Recycling programs. Grossman testified to the limited market for the recycled plastic material as well as the degradation and inferior quality of the product. Saloner testified that the discounted cash-flow would be negative if it were computed by Merino's methodology with either the fact assumptions set forth in the offering memorandum or the assumptions in Saloner's own report.

In this type of leasing transaction, if the discounted cash-flow is negative, the investor never could earn a profit. *Soriano v. Commissioner, supra*, at 55-56. If there

is no opportunity to make a profit by leasing Sentinel EPE Recyclers, petitioner is unlikely to have been motivated to invest by an objective of earning an economic profit. *Id.* at 56.

We have found as a fact that the fair market value of the Sentinel EPE Recycler was not in excess of $50,000 in 1981. We base this conclusion primarily on the fact that comparable products were available for that price and less.

We note that the traditional measure of fair market value does not by itself establish the economic viability of a v[illegible]ture involving leased assets. However, a projected cash-flow analysis provides a means of determining whether the transaction realistically had any possibility for economic profit. See *Soriano v. Commissioner, supra.* Such projections are, in effect, a determination of the fair market value of the leased interest.

Here the fair market value of each recycler was $50,000 ($300,000 for the six required by Clearwater), the monthly rental payment for Clearwater was $100,917, and the advance rental payment by Clearwater was $605,500. The advance lease payment was twice the fair market value of the assets and each month's lease payment was one-third of the total amount of the assets' fair market value. This evidence strongly suggests indifference towards economic profit. *Soriano v. Commissioner, supra* at 56-57.

The financial projections included in the offering memorandum were not met. Although the operational failure of a transaction does not destroy an otherwise valid profit objective, it is a relevant factor to consider in determining whether an adequate investigation was made prior to the investment and whether the objective to earn an economic profit existed at the time the transaction was entered into. *Thomas v. Commissioner,* 84 T.C. 1244, 1278 (1985), affd. 792 F.2d 1256 (4th Cir. 1986).

Lack of profit objective has also been found where the size of the nonrecourse notes and other terms of the lease are determined without negotiation, *Fox v. Commissioner*, 80 T.C. 972, 1009 (1983); where the investors or their agents fail to ascertain independent appraisals of the assets involved, *Soriano v. Commissioner, supra* at 57; and where the general partner and/or promoters have considerable prior experience in structuring tax shelters, *Seaman v. Commissioner*, 84 T.C. 564, 589 (1985).

Petitioner is an educated, sophisticated investor who, at the time he invested, was a highly-paid lawyer looking to shelter income. The promoters were experienced in tax sheltering income but had little knowledge of the plastics industry. The promotional materials emphasized projected tax savings and the price paid for the recyclers was grossly inflated.

According to the offering memorandum, Winer, Clearwater's general partner, was neither prohibited from engaging in competitive activity nor compelled to devote any time to the business except to the extent "in his absolute discretion" he deemed necessary. Actually, Winer did very little investigation of the recyclers and the transaction in general.

Although the evidence suggests that some correspondence occurred between petitioner, Winer, and Bambara, no positive action was taken by anyone involved with Clearwater regarding the lack of operations by end-users. In passive operations such as leasings, the care exercised in overseeing the performance of duties assigned to third parties is of particular importance. *Flowers v. Commissioner*, 80 T.C. 914, 932 (1983).

Winer was actually unconcerned about the six recyclers because that was not part of the formula. The return on the investment in the recyclers did not come from actually running the machines at all. The testimony and evidence supporting Winer's attempt to monitor the movement and

operation of the recyclers is unpersuasive. Such evidence shows more about the level of sophistication of the promoters and their attempts to cover up their true objectives by creating a "paper trail". See *Schillinger v. Commissioner,* T.C. Memo. 1990-640.

Petitioner claims that the Plastics Recycling programs were not promoted by anyone who was experienced with tax shelter income. On the contrary, Grant and Roberts advertised their services as relating to "tax sheltered investments" and Winer had considerable experience in such matters. The Clearwater offering memorandum specifically included the possibility that some of the parties involved in the transaction could be determined to be acting as promoters.

Regardless of how reasonable it may be to rely upon one's professional adviser, taxpayers may not hide behind such persons where there is no realistic opportunity to make a profit exclusive of tax benefits. Economically speaking, no investor would put money into a Plastics Recycler program except for the more than 200 percent return from Federal income tax savings. It is quite apparent that Clearwater's actual purpose was to act as a pass-through entity.

Taking into account the relevant factors, we conclude that petitioners did not enter into the transactions with Clearwater to lease and sublicense recycling equipment with either a subjective business purpose or an actual and honest objective of making a profit.

III. *The Safe-Harbor Leasing Rules*

The parties have raised the question whether the Plastics Recycling leasing programs literally comply with all of the requirements of section 168(f)(8). Respondent argues that petitioners have not literally complied with the requirements of section 168(f)(8) because F & G has not shown compliance with the minimum investment require-

ment of 10 percent of the adjusted basis of the property. Sec. 168(f)(8)(B)(ii). Petitioner contends that the minimum investment requirement was always satisfied.

Because of our holding that the Clearwater transaction is so lacking in economic substance that it must be disregarded for Federal income tax purposes, we consider it unnecessary and inappropriate for us to decide this further issue.

IV. *Investment Tax Credit and Business Energy Credit*

Petitioners claimed both the investment tax credit and business energy credit on their 1981 Federal income tax return. Both credits purportedly were passed through Clearwater from F & G pursuant to an election made under section 48(d)(1) based on the inflated cost basis of the Sentinel Recyclers.

Petitioners are not entitled to the claimed tax credits. Investment tax credits are designed to stimulate the formation of venture capital and are not intended to create a new economy consisting of paper transactions. *Beck v. Commissioner,* 85 T.C. 557, 579-580 (1985). In the present case, petitioner was not purchasing an interest in a recycler, he was purchasing a tax benefit. *Friendship Dairies, Inc. v. Commissioner,* 90 T.C. 1054, 1067 (1988).

V. *Additions to Tax*

A. *Sec. 6653(a) Negligence*

Section 6653(a)(1) imposes an addition to tax equal to 5 percent of the underpayment if any part of an underpayment of tax is due to negligence or intentional disregard of rules or regulations. An additional amount is added to tax under section 6653(a)(2), equal to 50 percent of the interest payable with respect to the portion of the underpayment attributable to negligence.

Petitioner has the burden of proving error in respondent's determination of an addition to tax attributable to negligence. Rule 142(a); *Luman v. Commissioner,* 79 T.C. 846, 860-861 (1982); *Bixby v. Commissioner,* 58 T.C. 757, 791-792 (1972). Negligence is defined as the failure to exercise the due care that a reasonable and ordinarily prudent person would exercise under the circumstances. *Marcello v. Commissioner,* 380 F.2d 499, 506 (5th Cir. 1967), affg. in part and remanding in part 43 T.C. 168 (1964) and T.C. Memo. 1964-299; *Neely v. Commissioner,* 85 T.C. 934, 947 (1985).

The question is whether a particular taxpayer's actions were reasonable in light of his experience, the nature of the investment or business, and his actions in connection with the transactions. *Henry Schwartz Corp. v. Commissioner,* 60 T.C. 728, 740 (1973).

We have held that a taxpayer may rely upon his adviser regarding matters uniquely within his adviser's field of expertise. *Patin v. Commissioner,* 88 T.C. 1086, 1130-1131 (1987), affd. without published opinion sub nom. *Hatheway v. Commissioner,* 856 F.2d 186 (4th Cir. 1988), affd. without published opinion sub nom. *Skeen v. Commissioner,* 864 F.2d 93 (9th Cir. 1989), affd. without published opinion 865 F.2d 1264 (5th Cir. 1989), affd. sub nom. *Gomberg v. Commissioner,* 868 F.2d 865 (6th Cir. 1989).

Petitioner had little knowledge of the recycling business though he does claim experience in investments in natural resources. He relied on the purported value of the Sentinel EPE Recyclers set out in the offering memorandum and on the statements made by the promoters. Petitioner made no attempt to verify the value of the recyclers by seeking the opinion of a reliable independent third party. *Rybak v. Commissioner,* 91 T.C. 524, 565 (1988).

The projected tax benefits to each of the investors were mentioned at three points in the offering memorandum.

In 1981 alone, for each $50,000 invested, the purchaser was proected to receive $86,328 in investment and energy tax credits and $39,399 in tax reductions. Petitioners claimed a reduction of taxes in year one equal to approximately $2.51 for every dollar invested. In essence, they did not have any of their own net capital invested in the transaction for any extended period of time. More simply, except for a few weeks at the beginning, petitioners never had any money in the deal. A reasonably prudent person would have asked a qualified tax adviser if this windfall were not too good to be true. *McCrary v. Commissioner*, 92 T.C. 827 (1989).

The evidence convinces us that petitioner knew that he was buying a program that consisted chiefly of tax benefits and that he participated in the Plastics Recycling programs to earn tax benefits. In claiming those benefits on their tax returns without making further inquiry, petitioners negligently disregarded rules and regulations.

Petitioner argues that he relied on the advice of paid experts when deciding to invest and, therefore, exercised due care and was not negligent. His adviser Gordon, who reviewed the promotional materials, was paid to locate investors for the Clearwater transaction. Gordon essentially was in the position of a finder of the tax-oriented transaction. Petitioner will not be relieved of negligence on the basis of his purported employment of Gordon's services.

B. *Sec. 6659 Valuation Overstatement*

Respondent also determined additions to tax under section 6659 for an underpayment attributable to a valuation overstatement. A valuation overstatement is a valuation which exceeds the correct valuation by 150 percent or more. Sec. 6659(c). Here, assets with approximate fair market values of $50,000 were valued by petitioners at $1,162,666 each. Petitioners' valuations are by definition overstated within the meaning of section 6659.

VI. *Sec. 6621(c) Tax-Motivated Transactions*

The final question here is the interest imposed on tax-motivated transactions by section 6621(c). Prior to the Tax Reform Act of 1986, subsection (c) was designated subsection (d). Pub. L. 99-514, sec. 1511(a), 100 Stat. 2085, 2744. The increased rate of interest is 120 percent of the statutory rate imposed on underpayments if the underpayment exceeds $1,000 and is attributable to a tax-motivated transaction (as defined in section 6621(c)(3)). The increased interest is effective only with respect to interest accruing after December 31, 1984, notwithstanding that the transaction was entered into prior to that date. *Solowiejczyk v. Commissioner,* 85 T.C. 552 (1985), affd. per curiam without published opinion 795 F.2d 1005 (2d Cir. 1986).

A tax-motivated transaction includes any valuation overstatement within the meaning of section 6659(c). Sec. 6621(c)(3)(A)(i). Further, a tax-motivated transaction includes any sham transaction. Sec. 6621(c)(3)(A)(v). Since we find that the Plastics Recycling leasing program is a sham transaction, by definition the programs are tax motivated. Accordingly, respondent's determination as to the applicable interest rate for deficiencies attributable to tax-motivated transactions is sustained and the increased rate of interest applies for the taxable year in issue.

To reflect the foregoing,

Decision will be entered for respondent.

APPENDIX C

STATUTORY PROVISIONS INVOLVED

1. Section 6659 of the Internal Revenue Code of 1954, 26 U.S.C. 6659, as added by the Economic Recovery Tax Act of 1981, Pub. L. 97-34, § 722(a), 95 Stat. 341-42, effective for returns filed after December 31, 1981, and prior to its amendment by the Tax Reform Act of 1984, Pub. L. 98-369, § 155(c), 98 Stat. 693-94, effective for returns filed after December 31, 1984, and its repeal by the Omnibus Budget Reconcilation Act of 1989, Pub. L. 101-239, § 7721(c)(2), 103 Stat. 2399, effective for returns the due date of which (determined without regard to extensions) is after December 31, 1989, provided:

§ 6659. Addition to tax in the case of valuation overstatements for purposes of the income tax

(a) Addition to the tax. If—

(1) an individual, or

(2) a closely held corporation or a personal service corporation, has an underpayment of the tax imposed by chapter 1 for the taxable year which is attributable to a valuation overstatement, then there shall be added to the tax an amount equal to the applicable percentage of the underpayment so attributable.

(b) Applicable percentage defined. For purposes of subsection (a), the applicable percentage shall be determined under the following table:

If the valuation claimed is the following percent of the correct	The applicable valuation-percentage is:
150 percent or more but not more than 200 percent	10
More than 200 percent but not more than 250 percent	20
More than 250 percent	30

(c) Valuation overstatement defined.—

(1) In general.—For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return exceeds 150 percent of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

(2) Property must have been acquired within last 5 years. This section shall not apply to any property which, as of the close of the taxable year for which there is a valuation overstatement, has been held by the taxpayer for more than 5 years.

(d) Underpayment must be at least $1,000.—This section shall not apply if the underpayment for the taxable year attributable to the valuation overstatement is less than $1,000.

(e) Authority to waive. The Secretary may waive all or any part of the addition to the tax provided by this section on a showing by the taxpayer there was a reasonable basis for the valuation or adjusted basis claimed on the return and that such claim was made in good faith.

(f) Other definitions.—For purposes of this section—

(1) Underpayment.—The term "underpayment" has the meaning given to such term by section 6653(c)(1).

(2) Closely Held Corporation.—The term "closely held corporation" means any corporation described in section 465(a)(1)(C).

(3) Personal Service Corporation.—The term "personal service corporation" means any corporation which is a service organization (within the meaning of section 414(m)(3)).

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Supreme Court, U.S.
FILED
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No. 93-878

In the Supreme Court of the United States

OCTOBER TERM, 1993

HAROLD M. PROVIZER AND JOAN PROVIZER,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

DREW S. DAYS, III
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

ANN B. DURNEY
LINDA E. MOSAKOWSKI
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 514-2217

QUESTION PRESENTED

Whether an underpayment of tax is "attributable to" a "valuation overstatement"—and is therefore subject to the addition to tax imposed by Section 6659(e) of the Internal Revenue Code, 26 U.S.C. 6659(e)—when the relevant transaction involved a significant overvaluation of property and lacked economic substance.

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In the Supreme Court of the United States

OCTOBER TERM, 1993

No. 93-878

HAROLD M. PROVIZER AND JOAN PROVIZER,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-6a) is unpublished, but the decision is noted at 996 F.2d 1216 (Table). The opinion of the Tax Court (Pet. App. 7a-62a) is reported at 63 T.C.M. (CCH) 2531.

JURISDICTION

The judgment of the court of appeals was entered on July 7, 1993. On September 24, 1993, Justice Stevens extended the time to file a petition for a writ of certiorari to and including December 4, 1993. The petition was filed on December 3, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1981, Packaging Industries, Inc., manufactured and sold six Sentinel EPE Recyclers to ECI Corporation for $5,886,000. The recyclers were, in turn, sold by ECI to F&G Corporation (Pet. App. 2a, 25a). F&G leased the recyclers to a limited partnership called Clearwater Group. Clearwater contemporaneously licensed the recyclers to FMEC Corporation, which sublicensed them back to the manufacturer, Packaging Industries (*id.* at 2a, 25a-26a). These transactions "were structured in such a way that all of the payments" due among the various entities offset each other (*id.* at 2a, 46a, 52a). Packaging Industries then sublicensed the recyclers to entities for use in recycling plastic scrap (*id.* at 2a, 27a). This series of transactions is hereafter referred to as the "Clearwater Transaction."

In November 1981, petitioner Harold Provizer paid $8,333 for a one-sixth interest in a general partnership (DL & Associates) that owned a partnership share of the Clearwater Group (Pet. App. 2a, 24a). On their 1981 federal income tax return, petitioners claimed three tax benefits from their participation in this transaction:[1] (i) an investment tax credit of $7,195; (ii) a business energy investment tax credit of $7,195; and (iii) an operating loss of $6,668 (*id.* at 2a, 12a-13a).

In April 1986, the Commissioner of Internal Revenue issued a notice of deficiency disallowing the deductions and credits that petitioners claimed with

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[1] Joan Provizer is a party to this suit because she filed a joint return with her husband, Harold, for 1981 (Pet. App. 12a).

respect to the Clearwater Transaction (Pet. App. 8a). The Commissioner determined that petitioners owed additional income taxes for 1981 in the amount of $17,724 and were also subject to additions to tax for a valuation overstatement ($4,317) and for negligence ($866 plus 50% of the interest due on the deficiency) and an increased rate of interest pursuant to 26 U.S.C. 6621(c) (Pet. App. 2a-3a, 8a). Petitioners sought review of these determinations by filing a timely petition in Tax Court (*id.* at 3a).[2]

2. The Tax Court determined that the Clearwater Transaction was a sham that lacked economic substance and business purpose. In reaching that conclusion, the court found that the fair market value of each recycler in 1981 was no more than $50,000 (Pet. App. 39a), rather than the $1,162,666 upon which petitioners computed their share of deductions and tax credits (*id.* at 46a-50a). In determining that the transaction lacked economic substance, the court explained that "[t]he manner in which the transaction was structured, the lack of arm's-length dealings, and the discrepancy between the fair market value and purchase price on which the pass-throughs were based show the true nature of these transactions" (*id.* at 51a). The court noted that, when the actual fair

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[2] Similar deficiencies and additions to tax were asserted against other participants in the Clearwater Transaction. Those taxpayers also filed petitions in the Tax Court. Petitioners' case was selected as the lead case. Many of the other taxpayers have agreed to be bound by the outcome of this litigation with respect to all deductions, credits, and additions to tax, as well as the increased rate of interest resulting from their participation in the Clearwater Transaction (Pet. App. 9a).

market value of the recyclers is taken into account, cash-flow analysis demonstrates that the transaction had no realistic possibility for economic profit (*id.* at 56a). As the court observed, "a grossly inflated purchase price which has [no] relationship to fair market value was conjured up to maximize the available deductions and credits" (*id.* at 51a).

The Tax Court concluded that the Clearwater Transaction was so lacking in economic substance that it must be disregarded for federal income tax purposes: the claimed tax deductions and credits resulting from the transaction were therefore properly denied (Pet. App. 59a). The court also sustained imposition of the addition to tax under Section 6659 for a "valuation overstatement" because assets with a fair market value of $50,000 were valued on petitioners' return at $1,162,666—a valuation that exceeded the correct value by more than 150% (Pet. App. 61a). See 26 U.S.C. 6659(c).

3. The court of appeals affirmed. The court concluded that the Tax Court had correctly determined that the Clearwater Transaction was a sham (Pet. App. 4a). With respect to the addition to tax for valuation overstatement, the court of appeals explained that "when an underpayment of taxes is caused by disallowance of a deduction for lack of economic substance and the lack of economic substance is due to an overvaluation, 'the deficiency is attributable to an overstatement of value and is subject to the penalty under section 6659'" (*id.* at 5a, quoting *Illes* v. *Commissioner*, 982 F.2d 163, 167 (6th Cir. 1992), cert. denied, 113 S. Ct. 1579 (1993)). Because the transaction at issue in this case "was found to be a sham largely because the recyclers were overvalued," the

court of appeals held that the addition to tax was properly imposed (Pet. App. 5a).

ARGUMENT

1. At the time this case arose, Section 6659 of the Internal Revenue Code imposed an addition to tax of up to 30% on any underpayment of tax "attributable to a valuation overstatement." 26 U.S.C. 6659.[3] Under this statute, a "valuation overstatement" occurs when a taxpayer reports on his tax return either a value or an adjusted basis for property that is 150% or more of the correct valuation or adjusted basis. 26 U.S.C. 6659(c). The court of appeals correctly held in this case that an addition to tax under Section 6659 is appropriate when the taxpayer's underpayment of tax is "attributable to" a significant overvaluation of property for a transaction that lacks economic substance. Pet. App. 5a. The court's conclusion tracks the plain language of the statute. See *Illes* v. *Commissioner*, 982 F.2d 163, 167 (6th Cir. 1992) (since the entire artifice of the shelter was based on the overvaluation of assets, the underpayment is attributable to a valuation overstatement), cert. denied, 113 S. Ct. 1579 (1993); *Gilman* v. *Commissioner*, 933 F.2d 143, 151 (2d Cir. 1991) (lack of economic substance was due in part to the overvaluation and thus the underpayment was attributable to the valuation overstatement), cert. denied, 112 S. Ct. 871 (1992); *Massengill* v. *Commissioner*, 876 F.2d 616,

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[3] Section 6659 of the Internal Revenue Code was repealed by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(c)(2), 103 Stat. 2399. Provisions similar to those formerly contained in Section 6659 are now found in Section 6662(e) of the Code. See 26 U.S.C. 6662(e) (Supp. I 1989).

619-620 (8th Cir. 1989); *Rybak* v. *Commissioner*, 91 T.C. 524, 566-567 (1988).

2. Contrary to petitioners' contention, the decision of the court of appeals does not conflict with the decisions of the Fifth Circuit in *Todd* v. *Commissioner*, 862 F.2d 540 (1988), and *Heasley* v. *Commissioner*, 902 F.2d 380 (1990), or with the decision of the Ninth Circuit in *Gainer* v. *Commissioner*, 893 F.2d 225 (9th Cir. 1990). Those cases did not involve the disallowance of credits or deductions for transactions that lacked economic substance. Instead, in both *Todd* and *Gainer*, the claimed deductions were disallowed because the property at issue had not been "placed in service" during the taxable year.[4] In that circumstance, the taxpayers' valuation of the property had "no impact whatsoever on the amount of tax actually owed." *Todd* v. *Commissioner*, 862 F.2d at

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[4] Petitioners mistakenly contend (Pet. 12) that, because the Tax Court found (Pet. App. 54a) that the recyclers had not been shipped to an end-user by the end of 1981, the Tax Court implicitly disallowed the deductions and tax credits on the "independent basis" that the recyclers had not been placed in service. The court's findings with respect to the shipment of the recyclers was integral to its explanation that the Clearwater Transaction lacked any business purpose (*id.* at 53a-58a). The court made no express findings as to when the property was actually placed in service. This is presumably because petitioners are lessors of the equipment rather than users. Equipment acquired for lease in a taxpayer's leasing venture can be "placed in service" at the time held out for lease notwithstanding the end-user's need to take additional steps to make the equipment operational. *Cooper* v. *Commissioner*, 88 T.C. 84, 113-114 (1987) (property held for leasing to others in a profit-motivated leasing venture is placed in service when it is first held out for lease); *Waddell* v. *Commissioner*, 86 T.C. 848, 897-898 (1986) (same), aff'd, 841 F.2d 264 (9th Cir. 1988).

543. See also *Gainer* v. *Commissioner*, 893 F.2d at 228 ("Even if Gainer had correctly valued the container, the underpayment of tax would be the same because the container was not placed in service.").

In the present case, by contrast, the Tax Court found that the recycling machinery was significantly overvalued on petitioners' return and that the Clearwater scheme was an economic sham (Pet. App. 46a-56a). Since the tax credits were claimed with respect to the machinery's overvalued basis, the petitioners' underpayment of tax is attributable to that valuation overstatement and the addition to tax under Section 6659 was properly imposed (Pet. App. 5a).[5] See also *McCrary* v. *Commissioner*, 92 T.C. 827, 859 (1989) (an addition to tax is proper under Section 6659 when a valuation overstatement is "an integral part of or is inseparable from the ground found for disallowance of an item"). The holding of the court of appeals in this case is thus consistent with *Todd* and *Gainer*, not in conflict with them.

Finally, in *Heasley*, the Commissioner determined tax deficiencies on a number of alternative grounds,

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[5] Petitioners err in relying (Pet. 9) on the "Blue Book" explanation of Section 6659 in the report issued by the Staff of the Joint Committee on Taxation, 97th Cong., 1st Sess., *General Explanation of the Economic Recovery Act of 1981*, at 333 (1981). The explanation states that whether a tax underpayment is attributable to a valuation overstatement will be determined after taking into account any "other" proper adjustments to tax liability. *Ibid.* The Blue Book formula is appropriate when there are several different types of errors by the taxpayer in the same year. It does not apply when a taxpayer's entire scheme was exposed as a sham and the associated credits and deductions claimed by the taxpayer are disallowed.

"including, among others, that petitioners did not have a profit objective, that the EMS units were not qualifying property, *that they were not placed in service*, and that the units were overvalued." *Heasley* v. *Commissioner*, 55 T.C.M. (CCH) 1748, 1754 (1988) (emphasis added). The taxpayers conceded in *Heasley* that they were not entitled to the investment tax credits they had claimed, but they declined to state any specific basis for their concession. They then argued that, since they had conceded the deficiencies, "it is impossible to determine the reason for any understatement" (*ibid.*) and they therefore should not be held liable for an addition to tax under Section 6659. The Fifth Circuit accepted that contention, concluding that, when a deduction or credit is disallowed in its entirety, the underpayment can not be said to be attributable to a "valuation overstatement" but is instead "attributable to claiming an improper deduction or credit." 902 F.2d at 383.

Although the Commissioner does not agree with the seemingly broad language of the *Heasley* decision, *Heasley* did not involve a situation in which the taxpayer's return relied on a substantial overvaluation of property in claiming tax benefits from a transaction that the court found lacked economic substance. Neither in *Heasley* nor any other decision has the Fifth Circuit directly ruled whether application of the Section 6659 addition to tax would be warranted in that context. In all prior cases where those precise facts have been presented, the courts of appeals have consistently reached the conclusion that the Section 6659 addition to tax properly applies. See pages 5-6, *supra*. There is thus no present direct

conflict in the decisions of the courts of appeals. Further review is therefore not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

LORETTA C. ARGRETT
Assistant Attorney General

ANN B. DURNEY
LINDA E. MOSAKOWSKI
Attorneys

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COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

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REPLY MEMORANDUM FOR THE PETITIONERS

STUART A. SMITH *
JORDAN I. BAILOWITZ
PIPER & MARBURY
31 West 52nd Street
New York, NY 10019-6118
(212) 261-2000
Attorneys for Petitioners
* Counsel of Record

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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REPLY MEMORANDUM FOR THE PETITIONERS

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1. In his Brief in Opposition (p. I), the Solicitor General's formulation of the question presented embraces the position of the court below and the Second and Eighth Circuits, *viz.*, that the Section 6659 overvaluation penalty automatically applies in any transaction that involves "a significant overvaluation *and* lack[s] economic substance" (emphasis supplied). But the Solicitor General errs in his assertion (Br. in Opp. 5) that "[t]he court's decision tracks the language of the statute." Quite to the contrary, his reading seriously distorts the statutory text and has been rejected by both the Fifth and Ninth Circuits. As we have pointed out (Pet. 7-9), Section 6659(a) imposes the penalty where there is "an underpayment of the tax . . . which is attributable to a valuation overstatement" (Pet. App. C 63a). The critical statutory term is "attributable," *i.e.*, there must be a direct proximate causative relation-

ship between the overvaluation statement and the underpayment in tax.

The following hypothetical demonstrates the unsoundness of the government's reading of the statute. Suppose taxpayer A donates a painting to X, a charitable organization. Thereafter, A obtains an appraisal that the painting is worth $10,000 and thereafter claims a charitable contribution deduction in the amount of $10,000. On audit, the Commissioner determines that: (a) the fair market value of the painting is only $1,000; and (b) the transaction lacked economic substance because the taxpayer never properly transferred possession of the painting to the charity. As a result, the Commissioner disallows the deduction.

On these facts, the Section 6659 overvaluation penalty cannot apply because the underpayment of the tax rests upon a ground that is wholly independent of any overvaluation statement, *viz.*, that the transaction lacked economic substance. By the same token, if the donee organization turned out not to be a qualified charity, the result would be precisely the same—disallowance of the deduction but no overvaluation penalty. Any other result would improperly stretch—or as the Second Circuit even conceded, "somewhat strain" [1]—the plain meaning of Section 6659 to apply to any case in which there is an overvaluation statement with regard to the basis or value of property.

Here, too, it is plain that petitioner's overvaluation statement was not the direct cause of the underpayment. Although the Tax Court found that the value of the machine was overstated, it also disallowed the claimed tax benefits on the grounds that the transaction lacked economic substance, business purpose and profit motive (Pet. App. A 51a-58a). Indeed, the government simply ignores

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[1] *See Gilman v. Commissioner*, 933 F.2d 143, 151 (2d Cir. 1991), *cert. denied*, 112 S.Ct. 871 (1992).

our analysis (Pet. 11-12) that if the underpayment in tax in this case were solely "attributable to" the overvaluation statement, the Tax Court would have conformed its decision to its finding that the machine was worth $50,000 and partially allowed the claimed tax benefits. But the Tax Court did not so rule. Rather, it upheld the Commissioner's total disallowance of petitioner's claimed credits. It is therefore clear that the underpayment in tax was not "attributable to" the overvaluation statement. If, as this Court has ruled, " 'penalty statutes are to be construed strictly' " (*Commissioner v. Acker*, 361 U.S. 87, 91 (1959), quoting from *Federal Communications Commission v. American Broadcasting Co.*, 347 U.S. 284 (1954), the Section 6659 penalty cannot apply to such a case.

2. Since this Court previously considered the question presented when the taxpayers in *Gilman* and *Illes* [2] sought certiorari, the issue has assumed far greater significance. Indeed, the Solicitor General does not challenge our submission (Pet. 13-14) with respect to the administrative importance of the question presented in this test case which affects the liabilities of thousands of taxpayers estimated to total $33 million, and its continuing importance as an issue of statutory construction under the Internal Revenue Code (Br. in Opp. 3 n.2, 5 n.3). Instead, he simply argues (Br. in Opp. 7-8) that there is no conflict between the decision below and the comparable transaction in *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990). But his attempted distinctions between this case and *Heasley* are unavailing. Here, as in *Heasley*, the taxpayer's claimed credits—based upon an overvaluation statement—were totally disallowed. Moreover, here, as in *Heasley*, petitioner's return contained an overvaluation statement upon which tax benefits were claimed. Under the reading of Section 6659 by the Fifth Circuit in

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[2] *Illes v. Commissioner*, 982 F.2d 163 (6th Cir. 1992), *cert. denied*, 113 S.Ct. 1579 (1993).

Heasley, petitioner's underpayment therefore cannot be said to be "attributable to a valuation overstatement." As the court of appeals there stated,

> Whenever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit. In such a case, the underpayment is not attributable to a valuation overstatement. Instead, it is attributable to claiming an improper deduction or credit.

902 F.2d at 383. Thus, the significance of *Heasley* is that the Fifth Circuit rejected the Tax Court's holding—and the decisions of the Second and Eighth Circuits—that the mere existence of an overvaluation statement on a tax return reporting a transaction that lacks economic substance automatically triggers the overvaluation penalty. Given the conflict of decisions on virtually identical facts, the Solicitor General's advice that "the Commissioner does not agree with the seemingly broad language of the *Heasley* decision" (Br. in Opp. 8) hardly constitutes a cogent basis upon which to foreclose review by this Court. Indeed, it is precisely that ruling in *Heasley* that is at odds with the decision below and those circuits it has followed.[3]

3. Finally, the government argues (Br. in Opp. 6-7) that the decision below does not conflict with *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988); and *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990), because those cases turned on the fact that the property at issue had not been placed in service during the taxable year. In support of this claimed distinction, the government claims (Br. in Opp. 6 n.4) that "The [Tax] court

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[3] There is no justification for the government's claim (Br. in Opp. 8) that "Heasley did not involve a situation in which the taxpayer's return relied on a substantial overvaluation of property in claiming tax benefits from a transaction that the court found lacked economic substance." The Fifth Circuit's opinion in *Heasley* makes it clear that in a transaction, which is in all respects comparable to the transaction at issue in this case, "the Heasleys overvalued each unit by $9500" even though they "were worth about $4800 each." *See* 902 F.2d at 382 and n.4.

made no express findings [in this case] as to when the property was actually placed in service."

This assertion, however, is flatly contradicted by the record. It is beyond question that the Tax Court specifically found that "Two of the machines never worked and remained for most of 1981 through 1985 in a PI warehouse" (Pet. App. B 54a) and this finding was affirmed by the court of appeals (Pet. App. A 4a). With respect to these machines, it is therefore clear that the property was never placed in service because it was not "placed in a condition or state of readiness and availability for a specifically assigned function." Treas. Reg. § 1.46-3(d)(1).[4] Accordingly, the Tax Court made the requisite finding on this point that establishes the conflict between the decision below and *Todd* and *Gainer*. In these circumstances, the Commissioner's disallowance necessarily stands on the additional independent ground that the equipment was not placed in service during the taxable year in which the tax credits were claimed. Under the plain terms of the statute, the Section 6659 penalty is therefore not applicable. *Todd v. Commissioner, supra*; *Gainer v. Commissioner, supra*; *Heasley v. Commissioner, supra.*

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[4] The Solicitor General mischaracterizes our argument with respect to the "placed in service" issue, claiming that we rely on the failure to ship the machines to end-users by the end of 1981 (Br. in Opp. 6 n.4). Quite to the contrary, our argument rests upon the findings of both courts below that the machines were never placed in service because they did not work. Moreover, the Solicitor General errs in his speculation (*id.*) that the Tax Court made no express findings as to when the property was placed in service because petitioner was a "lessor of the equipment." In fact, petitioner was a lessee and a licensor of the machines (Pet. App. A 25a-26a).

CONCLUSION

For the reasons stated above and in the petition for a writ of certiorari, the petition for a writ of certiorari should be granted.

Respectfully submitted,

STUART A. SMITH *
JORDAN I. BAILOWITZ
PIPER & MARBURY
31 West 52nd Street
New York, NY 10019-6118
(212) 261-2000
Attorneys for Petitioners

February 1994

* Counsel of Record